



The Influence of Audit Tenure and Audit Committee on Earnings Quality (Empirical Study on Chinese A-Shares Manufacture Companies Listed in Shenzhen Stock Exchange)

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Abstract

One of the Auditor and Audit committee role is to ensure the quality of corporate financial reporting process. This study aims to test the effect of the length of auditor tenure and audit committee on earning quality measured by the absolute value of discretionary accruals. A sample of 465 companies has been selected and data covering the period 2009-2014 has been collected from these firms, where 2325 observation were used in this analysis. The data collected from CSMAR and analyzed using GLS regression analysis.

This study found that the short audit tenure on Chinese listed company in Shenzhen Stock Exchange has a significance negative influence on earning quality, meanwhile this study found that audit committee which is measure by the size of the committee does not has a significance influence on earning quality. This study suggests that auditor should have a longer tenure to gain adequate knowledge of client's business. Moreover companies should strengthen the role of their audit committee in monitoring financial reporting process by improved their activity and financial knowledge of the member.

Keywords

Auditor tenure; Audit Committee; Earning Quality; Discretionary Accruals; China

INTRODUCTION

In doing a business a company needs capital to keep the business operating. One of the method to get this capital is investing by listed their stock in capital market. After being listed in capital market and raise their capital in there, Company's management has a responsibility to the capital providers to provide a financial report. Financial statement as primary source of independent verified information to capital providers about the performance of management, firm's operation and financial position, has an important role for capital providers in making investment decision. Since shareholders, creditors, and other financial statements users rely on the information reported in the financial statement to make a decision, therefore the credibility and the reliability of information reported is crucial.

To evaluate their investment, capital providers focus on earnings information reported by management. Earnings must

have a good quality as one of important indicator of company's financial health and the financial information that mostly use by investor. However the practice of earnings management can reduce the quality of earnings reported. Earnings management practice resulting in the earnings information which does not portrays the true underlying performance of business. Since they made a decision based on the information reported in financial statement which does not truly reflected the real financial condition of company, this kind of practice can mislead capital providers and other financial statement users in making decision.

To maintain the quality of earnings reported in financial statement and protect shareholders from managerial opportunistic and reporting behavior, assurance from independent parties and public accountant are needed. The assurance from auditor can improve the quality of financial reported by management (Arens and Elder, 2010). The

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Received: November 4, 2016

Revised: November 25, 2016

Accepted: December 16, 2016

audit process doing by independent auditors designed to determine whether the figures reported in financial statement present the firm's operating results and financial position in fair manner.

In giving a good assurance to the capital providers, auditor must have a good qualification. One of the qualification is the knowledge of client business industry and accounting system. This kind of qualification can be obtained from the time auditor working with the same client to have a better understanding about the client business. However, if auditor has been audit the same client for a long time, it can impair the independence and objectivity of auditor and lead to the development of economic and social bonds between the auditor and client due to the continuous involvement. One of the effects of long tenure is the auditors more likely to compromise on their client accounting and reporting choice in order to retain the client. Meanwhile short time of audit tenure also resulting in higher risk of audit failures. New auditor with insufficient client-specific knowledge will have to rely more heavily on the estimation and representation made by client firm (Gul et al., 2009). Gul et al. (2009) also suggest that auditors with short tenure maybe more lax in the early years of auditor-client relationship so that they can retain their job long enough to recoup the initial losses, resulting in lower quality of earnings reported. Until now, there have been some arguments about the effect of auditor tenure on earnings quality whether it will enhance the quality of earnings reported or vice versa.

Another way to enhance the quality of earnings reported is by the establishment of audit committee. Audit committee is one of corporate governance tools emphasis on audit quality and oversight financial reporting. audit committee make recommendations to the board on the selection of external auditors, liaison between senior financial managers and external auditor on issues such as the financial statements, audit process and internal control as well as oversee internal auditors and the external auditors to ensure that they act on the best interest of shareholders.

The External auditors and audit committee perform to ascertain the validity and reliability of corporate financial statements. However, regulators have questioned the effectiveness of audit committees and auditors in ensuring financial statement that are fairly stated and

minus earnings management practice. Dechow et al. (2010) mention there are six categories of determinants of earning quality: firm characteristic, financial reporting practices, governance and controls, auditors, equity market incentives and external factors (e.g political process, tax regulation or capital requirements). This study will examine the effect from auditor factor and governance factor on the earning quality.

As an emerging market, Chinese stock market is in a high growth stage. Consequently investor in Chinese stock market must rely on reliable and consistent financial information to identify good companies and their investment evaluation in the market. The majority of investor in Chinese stock market are individual investor who must use the publicly available information disclosed in financial report to evaluate their investment (Sutthisit et al., 2012), Therefore to protect this minority shareholders against managerial opportunistic from reported unreal condition in financial statement, independent and objective assurance from auditor and monitoring from audit committee is important. After the formation of audit committee, it won't give a guarantee that the audit committee will be effective in doing their roles especially for monitoring the financial reporting process and gives assurance that information reported in financial statement is free from earning management practice. This study will examine the effect of audit committee measure by the number of audit committee member. The unclear statement about the appropriate length of time of auditor to acquire an acceptable and reasonable level of client knowledge and gain the necessary acquaintance with the client's business and industry which improved the earning quality reported, encourage another research to be done.

Based on the description above, thereby the main research problems are as follows:

1. Does the length of Auditor-Client relationship has a significant influence on earnings quality in Chinese listed company?
2. Does the audit committee has a significant influence on earnings quality in Chinese listed company?

LITERATURE REVIEW AND HYPOTHESES

Audit Tenure and Earnings Quality

Some studies argue about the effect of audit tenure on earnings quality. Previous audit tenure studies have predicted that audit tenure affect the financial reporting quality (Chung and Kallapur, 2003; Gates et al., 2007) These studies shows that early audit tenure decrease earnings quality. These results due to the lack of client-specific knowledge and/or lack of independence due to the external auditor's incentive to maintain new client relationships (Meyers et al., 2003; Fairchild, 2008 and Davis et al., 2009). In addition other studies provide evidence of a positive link between audit tenure and earnings quality (Carcello and Nagy 2004; Ghosh and Moon, 2005), These findings are consistent with the theory that length of auditor-client relationship has a positive relation on earning quality since the length of tenure is used to achieve a specific knowledge of characteristic of the company resulting in higher quality audits.

After specific number of years, excessive familiarity can result and serve as a deterrent to the quality of financial reports. Long tenure is assumed lead to less objectivity in the auditor's behavior, where a "learned confidence" in the client is developed (Hoyle, 1987 on Johnson et al., 2002). According to Johnson et al., (2002) who divided tenure into three categories said the learning effect will diminish when the engagement exceeds eight years. They document higher unexpected accruals when auditor tenure is short than when its medium. Moreover, they find no evidence that a longer audit tenure is associated with lower unexpected accruals compared to the medium auditor-client relationship. Upon approaching the medium tenure category and extending beyond towards the long tenure, the independence of the auditor is jeopardized as a result of the auditor's excessive familiarity with client and its industry. The auditor is no longer motivated to innovate or diversify in the audit procedures at this stage of engagement.

Davis et al., (2009) inferred that management gains additional reporting flexibility with the progress in auditor tenure. This was evident in the direct positive effect the auditor tenure had on discretionary accruals. in example, Discretionary accruals increase with the progress in the audit tenure. Similiarly Chung and Kallapur (2003) found

that the audit tenure was inversely related to abnormal accruals.

Research have also used estimated discretionary accruals as proxy for audit quality (Dechow and Dicheve, 2002; and Krishnan, 2003) on (Adeniyi and Mieseigha, 2013). Their studies assume that higher estimated discretionary accruals reflect lower earnings quality and thus lower audit quality. Absolute discretionary accruals were found to decrease significantly through the passage of the audit firm tenure (Chen et al., 2008). The researchers findings are consistent with the argument that audit firm rotation might have adverse effect on the quality of earnings, and accordingly the accruals reported (Al Thuneibat et al., 2011).

From the effect of how investor perceived earning quality. Wiemann (2015) using earning response coefficient in proxy earning quality, found that investor perceived the lower earning quality in the early years and later years of audit tenure, they found that the highest perceived of earnings quality is on the 8.5 year. This study is not far from Johnson et al. (2002) who found that the optimal earning quality is reach on medium tenure of auditor.

Myers et al., (2003) examine the relation between auditor and earnings quality using both the signed and absolute value of discretionary accruals as proxies for earnings quality. Their results suggest that higher earnings quality is associated with longer auditor tenure, which they interpret as evidence that longer auditor tenure enables auditors to constraints management opportunistic behavior.

From several researches above this study draw a hypotheses that a short auditor tenure will reduce the chance of auditor to obtain better knowledge of client's business and make them lack of capability to detect earnings misstatement and earning management practice in the client's company resulting in lower earning quality reported by the company.

H1: Short audit tenure has a significant negative influence on earnings quality.

Audit Committee and Earnings Quality

Baxter and Cotter (2009) found that the formation of audit committee is associated with an increase in earnings quality. They found that the discretionary accruals decrease significantly in the following years of audit committee formation. The decreasing in the discretionary accruals indiciate that the

formation of audit committee is the effective way to reduce earnings management, since earnings management has an inverse measure with earnings quality, therefore the lower number of earnings management indicate the higher earnings quality reported.

Lin et al., (2009) study the effect of audit characteristic such as independent directors, financial expertise and size on abnormal accruals in Hongkong listed chinese company. They found that ownership concentration and present of government officials in independent directors is important determinants of negative association between audit committee characteristic and earnings management. Bala and Gugong (2015) found that Audit committee size and financial expertise has an inverse relationship on earnings management.

Berdard et al. (2004) and Jaggi et al. (2009) found a significantly negative relationship between earnings management and the existence of audit committee. Lin and Hwang (2010) using meta analysis shows that there is no significant relationship between the existence of an audit committee and earnings management based on either unweighted or weighed Stouffer combined tests.

From several research above the study draw a hypotheses that the size of audit committee has a positive influence on earning quality, because the more member consist in the committee the more knowledge has by the committee to detect earning management practice by the management and it can make the monitoring activities over financial reporting process effective.

Thereby the hypothesis as a following :
H2: Audit committee size has a significant positive influence on Earnings Quality

Earnings Management and Earnings Quality

Earnings quality and earnings management are two related concepts. Earning quality is equivalent to financial reporting quality and is a function of both the management and auditors. The management is responsible for the (non) financial information that they provide to the auditors, but both management and auditor are responsible for the (non) financial information provided to outsiders. Dechow et al.,(2010) define high quality earnings provide more information about the features of a firm's financial performance that are relevant to a specific decision made by decision-maker. Because this definition alone

is meaningless can not gives a clear understanding of high earning quality, therefore they add three features. these feature are (1) earning quality is defined only in the context of a specific decision model, (2) the quality of earnings depends on wheter it is informative about firm's financial performance, (3) earnings quality is jointly determined by the relevance of the underlying financial performance to the decision and by the ability of the accounting system to measure performance.

Healy and Wahlen (1999) defined earnings management as the practice that occurs when managers use judgment in financial reporting and in structuring transaction to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported numbers. Ball and Shivakumar (2008) conclude that low quality earnings are earnings which are managed upwardly. However, low quality earnings could also be earnings that are managed downwardly to postpone earnings to the next year to receive bonuses (Healy, 1985). Regardless the direction of earning management, once firms engage in earnings management practice their earning quality will be lower than when they do not engage in earnings management. Earning management and Earning quality concept can be related and generalized each other concept.

METHODS

The Study's Variables

Independent Variables

The independent variables in this study are audit tenure and audit committee. The main research is to see the effect of the length of auditor-client relationship on earnings quality (Johnson et al., 2002). Audit tenure is measured by the number of years auditor audit the client, because auditor who audits the client usually in a partner form and sometimes one of the partner changes in a certain year, therefore this study only use one partner who has longer experience with the firm client. If the firm switch to a new auditors without any partner from the last partner then the counting start from the beginning.

Audit committee is measure by the size of audit committee member. The bigger size of the audit committee expected results in better monitoring practice and higher earning quality because the committee will have much more knowledge and more ability to detect and

monitoring the financial reporting process, results in less earning management practice and higher earning quality.

Dependent Variable

The dependent variable in this study is earnings quality. Because earnings quality is unobservable, proxy is used to determined the earning quality. Discretionary accrual model is adopted to proxy earnings quality. Because discretionary accruals are accruals that arise through the discretion of management, thus makes discretionary accruals a good indirect measure of earning quality.

The Jones (1991) and modified Jones (Dechow et al., 1995) is most widely used model to measure earnings management through discretionary accruals. However, Kothari et al., (2005) argue that measure earnings management without controlling for firm performance will produce misspecification in the earnings management model.

This study will used the modified jones model and controlled firms performance by lagged return on asset (Aerts, 2012). The controlled has been put a place because performance-matched discretionary accruals measure enhance the reliability of the inferences from earnings management research. (Kothari et al., 2005).

Follows are the equation to obtain the discretionary accruals :

$$DA_t = TA_t - (a_1 \frac{1}{ASSET_{t-1}}) + a_2 (\frac{\Delta SALE_t - \Delta REC_t}{ASSET_{t-1}}) + a_3 \frac{PPE_t}{ASSET_{t-1}} + a_4 ROA_{t-1}$$

Where,

- Tat : Total accruals in the year t (Income before extraordinary income – cash flow operation)
- Asset t-1 : Total asset at end in the year t-1
- ΔSALEt : Change in sales in the year t from year t-1
- ΔRECT : Change in Accounts Receivable year t from year t-1
- PPE : Gross property, plant and equipment at the end in the year
- ROAt-1 : Return on Asset at end of the year t-1

The coefficient a1, a2, a3, and a4 will be estimated per year and obtain from OLS regression.

The absolute value of discretionary accruals |DA| represent earnings management because earnings management can be income-increasing or income-decreasing accruals. Bedard and Johnstone(2004); Klein (2002); and Abdul Rahman and Ali (2006) suggest that absolute value of abnormal accruals is a good proxy for the combined effect of be income-increasing or income-decreasing earnings management. Thus the high absolute value of the discretionary accruals indicate low earnings quality and vice versa.

Control Variables

1) Firm Size

Lobo and Zhou (2006) found that a large firm has a bigger chance to manage their earnings because of the business complexity and larger operation. The larger the firm the more complex system information in a company. Thus makes a difficulty in detect earning manipulation resulting in a lower earning quality reported.

2) Leverage

Defond and Jiambalvo (1994) fund that a company with a high leverage of debt has an incentive to manage earning upwards to satisfy the debt covenant.

3) ROE

ROE used as a proxy of profitability. Listed firms with lower profitability tend to have a higher chance to manage earnings, thus increase in ROE expected to have a negative influence on discretionary accruals and increase the earning quality.

4) Loss

Loss reflected losses on firm's financial condition which is one of the factor that encourage management to manage their earnings. A company experience loss in their net income has a much bigger incentive to manager their earnings by doing a big bath (Kallapur, 2008). Therefore resulting in higher level of

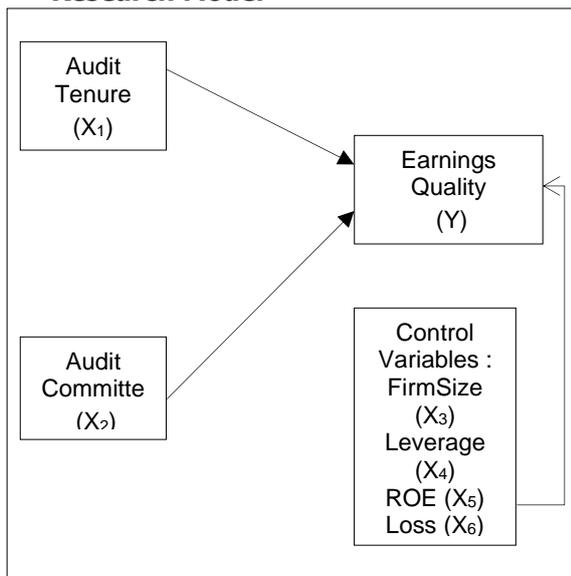
earning management and lower earning quality.

Shenzhen Stock Exchange during the period 2010-2014 and the annual report of the companies can be accessed in China Securities Market and Accounting Research Database (GTA/CSMAR).

For the sample, this study use purposive sampling method. Criteria for selecting samples as follows:

- a. The company should be listed on the Shenzhen stock exchange on the period 2009-2014
- b. The company that used in this study are specified into A share types, and a manufacture company.
- c. The company used in this study must have complete of information required over period 2009 -2014.

Research Model



Regression Model

The study attempt to find the relationship of audit tenure and audit committee on earnings quality. In addition following previous research client firm size, leverage, ROE and loss included as control variable.

$$|DA| = \beta_1 ATenure + \beta_2 ACommitte + \beta_3 FSize + \beta_4 Lev + \beta_5 ROE + \beta_6 Loss + \varepsilon$$

Where :

|DA| : Absolute Value of Discretionary Accruals

Population and Sample

The population in this research is Chinese A shared manufacture companies listed in

ATenure : Audit tenure measure by the number of years auditor audit the client

Acommitte : Audit Committee, measured based on the total number of audit committee members presented at the end of fiscal year

Fsize : Firm size, measure by natural log of total assets

Lev : Leverage measure by the ratio of total liabilities to total assets

ROE : Measured by Net profit divided average shareholder's equity

Loss : Measured by dummy variable, 1 if a company experience a loss, and 0 otherwise.

Data analysis methodology

This study used panel data therefore three tested will be used in analyzing the data. The first one is descriptive statistic to explain the variable of this study. The second is estimation method test, and the last is regression analysis. Eviews 9 is used to analyze the data.

RESULTS AND DISCUSSION

Description of Research Object

The population of this research manufacture company of A shares listed in shenzhen stock exchange, the number of population is 1236 companies. In accordance with the purposive sampling method used in this study, 465 companies selected as a sample with 5 years observation within the time period from 2010 until 2014. Bringing the total observation of this study as many as 2325 observations.

Data Analysis

Descriptive Statistic

Descriptive statistic anlysis described the variable used in this study by the mean, median maximum, minimum and standard deviation number. Results obtain in this study showed in table 4.1. In this study earning quality is proxied by the absolute value of discretionary accruals. The minimum value of Discretionary accruals in this study is 0.0000293 and the maximum value is 4.199672. The average discretionary accruals value is 0.09362 and standard deviation is 0.167022. The audit tenure variable minimum value is 1 while the maximum value is 5. The mean of auditor tenure is 2.1 and the standard deviation is

1.0566095, this result indicate the average auditor audit client in Chinese listed company are around 2.1 years within 5 years observation. The audit committee minimum value is 0 and maximum is 7, the number zero hows because not all the sample company use in this study already established audit committee since 2010, so

some of them still have zero audit committee size within 2010 until 2014. The average size of audit committee established by the Chinese listed company in this study is 2.749677. The standard deviation for audit committee is 1.520133.

Table 4.1 Descriptive statistic

| | N | Mean | Maximum | Minimum | Std.Dev |
|-----------------|------|----------|----------|-----------|-----------|
| DA | 2325 | 0.09362 | 4.199672 | 2.93E-05 | 0.167022 |
| Auditor Tenure | 2325 | 2.101505 | 5 | 1 | 1.0566095 |
| Audit Committee | 2325 | 2.749677 | 7 | 0 | 1.520133 |
| Firm Size | 2325 | 21.67621 | 25.86123 | 17.75689 | 1.167631 |
| Leverage | 2325 | 0.706904 | 118.291 | 0.002865 | 3.058119 |
| ROE | 2325 | 0.091791 | 25.1686 | -5.286353 | 0.778529 |
| Loss | 2325 | 0.110968 | 1 | 0 | 0.314160 |

Regression Analysis Model

The estimation method test aims to determine which model will be use in the regression analysis.

**Selected the Estimation Method
Chow Test**

Table 4.2 Chow test

Redundant Fixed Effects Tests

Equation : FEWEIGHTED

Test cross-section fixed effects

| Effects Test | Statistic | d.f. | Prob. |
|-----------------|-----------|------------|--------|
| Cross-section F | 2.226974 | (464,1854) | 0.0000 |

This test use to determine whether the regression model will use fixed effect or common effect method. If the probability of Cross-section F is more than 0.05 then common effect (pooled lesast square) will be used in this regression model, but if it is less

than 0.05 then the fixed effect method will be used. Based on the result obtain in this study, the probability of Cross-section F is less than 0.05, therefore The fixed effect method use in this study.

Hausman Specifiction Test

Table 4.3 Hausman test

Correlated Random Effects – Hausman test

Equation : RE

Test cross-section random effects

| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f | Prob. |
|----------------------|-------------------|-------------|--------|
| Cross-section random | 73.109405 | 6 | 0.0000 |

To assure that fixed model is the right model to analyze the regression model in this study, we use Hausman test to choose whether the model will use fixed effect or random effect. If the value of cross section random probability is more than 0.05 then the random effect method is choose but if otherwise the fixed

effect method will be used. Based on the result obtains (Table 4.3) it is show that the

probability value of cross section random is less than 0.05 therefore the fixed effect method is much suitable to use in this study rather than random effect.

From the two test above we can conclude that the panel data regression in this study used fixed effect method.

Regression Result

Table 4.5 Regression Result

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|-----------------|-------------|------------|-------------|--------|
| AUDITOR_TENURE | 0.004530 | 0.001084 | 4.179729 | 0.0000 |
| AUDIT_COMMITTEE | -0.000790 | 0.000896 | -0.882210 | 0.3778 |
| FIRM_SIZE | 0.052889 | 0.004257 | 12.42401 | 0.0000 |
| LEVERAGE | 0.010198 | 0.001055 | 9.669923 | 0.0000 |
| ROE | 0.012446 | 0.001801 | 6.911495 | 0.0000 |
| LOSS | 0.015805 | 0.003753 | 4.211397 | 0.0000 |
| C | -1.070259 | 0.091026 | -11.75770 | 0.0000 |

Influence of Audit Tenure on Earning Quality

To test whether the auditor tenure significantly influence the earning quality, its obtain from P-value-state. The regression result in table 4.5 show that auditor tenure probability value is 0.0000, with the significant level of 95%. The auditor p-value-stat in this study is less than 0.05, therefore the auditor tenure has a significant influence in earning quality.

From coefficient results we can see whether the auditor tenure has a positive or negative influence towards earning quality. The results from Table 4.5 shows that auditor tenure has a positive coefficient, the positive coefficient indicate that auditor tenure positively influence the discretionary accruals, which means decreasing the earning quality.

Based on descriptive statistic, the average year of auditor tenure use in this study is 2.7 years, it means the tenure is a short tenure (Johnson et al., 2002) and we found that the short auditor tenure has a positive influence on discretionary accruals, in an inverse has a negative influence earning quality, So the first hypotheses is accepted. A short auditor tenure in Chinese listed company reducing the earning quality reported. The conclusion can be draw form this result is a short tenure (under 3 years) is not enough time for auditor to obtain the knowledge of client characteristic, resulting in a lack of ability to detect misstatement or management practice in client company. This study support Johnson et al. (2002) whose found that a short auditor tenure associated with lower financial reporting quality and Myers et al. (2003) that a longer auditor tenure may have an ability to constraint earning management practice in a company due to better understanding of client's business.

Influence of Audit Committee on Earning Quality

The p-value-stat in table 4.5 shows that Audit committee p value is 0.3788, with the significant level of 95%. This result show that audit committee which is measured by size does not significantly influence earning quality. However, the coefficient is – 0.00079, a small number and negative coefficient indicates that audit committee negatively influence the discretionary accruals means has a positive influence on earning quality but not significant. Therefore the Second Hypotheses (H2) is rejected, audit committee size has a positive influence but not significant on earning quality. This means the bigger number of audit committee member doesn't guarantee the effectiveness of committee in monitoring financial reporting process and higher ability to detect earning management practice. Maybe this can be explained by the lack of financial expertise in the committee or the lack activity of audit committee, so they only become a decoration on the company without their effective roles in prevent earning management to produce a higher earning quality. This result support Lin (2011) whose using Chinese listed company sample found that audit committee size is not significantly related to earning management. Lin suggest Chinese regulator should strengthen the audit committee function. Xie et al. (2003) using 282 firm observation in S&P 500 report that audit committee size is also not significantly related to discretionary accruals.

CONCLUSION

Conclusion of study

First, this study found that the length of audit tenure influenced earning quality in Chinese listed company. The average years of tenure in Chinese listed company is around 2-3 years and this study found the engagement of audit tenure within 1-3 years has a negative

influence on earning quality. This length of time is not enough for auditor to obtain adequate knowledge and better understanding of client's business thus makes it difficult for auditor to detect earning misstatement and earning management in Chinese listed company, resulting in lower earning quality reported. Second, this study found that the size of audit committee does not have a significant influence on earning quality in Chinese listed company. This study suggests strengthening the role of audit committee in monitoring financial reporting process especially in the activity and financial knowledge of audit member. Even if there is lot of audit committee member does not guarantee they provide better monitoring to prevent earning management, if the size is big but they have a less meeting and does not have an adequate member with financial knowledge it might be difficult to detect the earning management and resulting in lower quality of earning reported.

Recommendation for further research

- a. Further research can use the bigger data than this study, such as use all industry or add another company from other china's stock exchange to draw a more larger conclusion of the effect of audit tenure and audit committee in china.
- b. Further research can extend the time of auditor tenure, to see the effect of long tenure in Chinese listed company.

Further research can use another characteristic of audit committee, such as the financial expertise and audit committee meeting number to see if the audit committee practice in china is effective and have a significant influence in reducing earnings management practice and has a significance influence in enhancing earnings quality.

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