

# Audit Quality and Earnings Management: Empirical Evidence on the Role of Auditor Characteristics and Regulatory Oversight

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## Abstract

This paper examines the relationship between audit quality and earnings management, drawing on empirical evidence from publicly listed firms. Using discretionary accruals as a proxy for earnings management and multiple auditor-based proxies for audit quality, the study evaluates whether higher audit quality constrains managerial discretion in financial reporting. The results indicate a significant negative association between audit quality and earnings management. Furthermore, the findings demonstrate that regulatory oversight strengthens the effectiveness of audit quality in limiting earnings manipulation. The study contributes to the audit literature by integrating auditor characteristics with institutional context and offers policy-relevant implications for auditors, regulators, and standard setters.

## Keywords

Audit Quality, Earnings Management, Auditor Independence, Regulatory Environment

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## 1. Introduction

The reliability of financial reporting is fundamental to investor confidence, capital market efficiency, and overall economic stability. Financial statements constitute a primary source of information for investors, creditors, regulators, and other stakeholders when assessing firm performance and making resource allocation decisions. In efficient capital markets, the credibility of this information underpins pricing mechanisms, contract enforcement, and governance arrangements. Consequently, any distortion in reported financial information has the potential

to generate significant economic costs.

This study focuses on publicly listed non-financial firms operating on the London Stock Exchange (LSE) in the United Kingdom over the period 2012-2021. The institutional setting provides a relevant context for examining audit quality and earnings management, given the presence of formal auditing standards, mandatory external audits, and an evolving regulatory framework governing financial reporting and auditor oversight.

Despite extensive regulatory reforms and continuous enhancements in auditing standards over recent decades, earnings management remains a persistent and widely documented concern in corporate reporting. High-profile accounting scandals and financial crises have repeatedly demonstrated that formal compliance with accounting standards does not necessarily guarantee high-quality financial reporting. Instead, managerial incentives and institutional weaknesses may create opportunities for earnings manipulation even in regulated environments.

Earnings management arises when managers exercise discretion in financial reporting choices with the intention of influencing reported earnings, often to meet market expectations, comply with debt covenants, smooth income streams, or enhance managerial compensation. From a positive accounting perspective, such behaviour can be understood as managers' rational responses to contracting incentives and political costs (Watts & Zimmerman, 1986).

Audit quality serves as a key external corporate governance mechanism designed to mitigate earnings management by enhancing the probability of detecting material misstatements and enforcing compliance with accounting and auditing standards. High-quality audits are expected to constrain managerial opportunism by increasing detection risk, reinforcing auditor independence, and imposing reputational and legal costs on both auditors and managers. From this perspective, auditing complements internal governance mechanisms such as boards of directors and audit committees.

Nevertheless, empirical evidence on the audit quality-earnings management relationship remains mixed. While many studies report a negative association, others find weak or insignificant effects, particularly in settings characterised by weak enforcement or institutional voids. These inconsistencies may be attributed to differences in audit quality proxies, methodological approaches, sample selection, and regulatory environments. As a result, there is a continuing need for empirical research that integrates audit quality attributes with broader institutional and regulatory contexts.

This study addresses these gaps by empirically examining the relationship between audit quality and earnings management while explicitly incorporating the moderating role of regulatory oversight within the context of the United Kingdom capital market. By drawing on evidence from publicly listed firms and integrating auditor characteristics with institutional context, the study contributes to the auditing literature and provides insights relevant to practitioners, regulators, and policymakers seeking to enhance financial reporting integrity.

## 1.1. Problem Statement

Despite the central role of auditing in safeguarding the credibility of financial reporting, persistent evidence of earnings management continues to raise concerns about the effectiveness of audit mechanisms. Prior empirical studies provide mixed and sometimes contradictory findings regarding the extent to which audit quality constrains earnings management. These inconsistencies are attributable to variations in audit quality proxies, methodological approaches, and institutional settings, as well as insufficient consideration of regulatory enforcement as a conditioning factor. Consequently, there remains limited consensus on whether, and under what conditions, audit quality effectively mitigates earnings management practices. This unresolved issue represents a significant problem for regulators, investors, and policymakers who rely on high-quality audits to enhance transparency and market confidence.

## 1.2. Research Aim and Objectives

The primary aim of this study is to empirically investigate the relationship between audit quality and earnings management, with particular emphasis on the moderating role of regulatory oversight. To achieve this aim, the study pursues the following specific objectives:

- i) to examine the impact of audit quality on earnings management in publicly listed firms;
- ii) to assess the role of auditor independence in strengthening the relationship between audit quality and earnings management;
- iii) to evaluate whether regulatory oversight enhances the effectiveness of audit quality in constraining earnings management;
- iv) to provide empirical evidence that informs auditing practice, regulatory policy, and future academic research.

## 2. Literature Review and Hypotheses Development

### 2.1. Conceptualising Audit Quality

Audit quality is commonly defined as the probability that an auditor will both detect material misstatements in financial statements and report them appropriately. Seminal work by DeAngelo (1981) conceptualises audit quality as a joint function of auditor competence and auditor independence, emphasising the role of reputational capital and litigation risk. Subsequent research has expanded this definition to include dimensions such as professional scepticism, audit effort, compliance with auditing standards, and the effectiveness of quality control systems within audit firms.

Larger audit firms are generally perceived to deliver higher-quality audits due to superior technical expertise, greater access to specialist resources, international networks, and stronger incentives to protect brand reputation. Empirical studies frequently document that Big N auditors are associated with higher earnings quality, lower discretionary accruals, and more conservative financial reporting. Audit

fees are often interpreted as reflecting audit effort and engagement risk, although excessive fee dependence may impair auditor independence. Audit tenure captures the trade-off between client-specific knowledge and the risk of familiarity threats, with mixed empirical evidence regarding its effect on audit quality.

## 2.2. Earnings Management and Measurement Approaches

Earnings management refers to the purposeful intervention in the financial reporting process to obtain private gains. The literature distinguishes between accrual-based earnings management and real earnings management. Accrual-based earnings management involves adjustments to accounting estimates and judgments, whereas real earnings management affects underlying business activities such as production, pricing, or discretionary expenditures. This study focuses on accrual-based earnings management due to its direct relevance to the audit process and its widespread use in prior research.

Discretionary accruals are the most commonly employed proxy for accrual-based earnings management. Models such as the Jones and Modified Jones models estimate normal accruals based on firm fundamentals and treat the residual component as discretionary (Jones, 1991). Although these models are subject to measurement error, they remain widely accepted due to their tractability and comparability across studies.

## 2.3. Review of Existing Empirical Studies

A substantial body of empirical research has examined the relationship between audit quality and earnings management across different institutional contexts. Early studies document that firms audited by large audit firms exhibit lower levels of discretionary accruals, suggesting that auditor size is positively associated with audit quality and negatively associated with earnings management. Subsequent research extends this line of inquiry by incorporating additional audit quality proxies such as audit fees, audit tenure, and auditor independence.

Empirical evidence from both developed and emerging markets generally supports the view that higher audit quality constrains earnings management, although the strength of this relationship varies across jurisdictions. For example, Alareeni (2019) reports that audit firm attributes are significantly associated with audit quality indicators, while Almarayeh, Aibar-Guzmán, and Abdullatif (2020) find that higher audit quality reduces earnings management in emerging market settings. Similarly, Alzoubi (2019) documents that effective audit mechanisms and internal audit functions limit earnings manipulation, and Duh, Knechel, and Lin (2020) show that audit firm knowledge sharing enhances audit quality and reporting outcomes.

However, other studies suggest that audit quality alone may be insufficient to curb earnings management in environments characterised by weak legal enforcement or limited regulatory oversight. These mixed findings highlight the importance of regulatory and institutional factors in shaping the effectiveness of audit quality.

Overall, the existing empirical literature indicates that while audit quality is an important determinant of earnings management, its effectiveness is contingent upon broader institutional and regulatory conditions. These findings underscore the need for further empirical investigation that integrates audit quality attributes with regulatory oversight, thereby motivating the focus of the present study.

## 2.4. Theoretical Framework

This study is grounded primarily in agency theory, which provides a robust framework for analysing the relationship between audit quality and earnings management. Agency theory posits that separation of ownership and control creates conflicts of interest between principals (shareholders) and agents (managers), giving rise to information asymmetry and opportunistic behaviour (Jensen & Meckling, 1976). Managers may have incentives to engage in earnings management to maximise personal benefits, such as performance-based compensation, job security, or reputation, even when such actions are not aligned with shareholders' interests.

Within this framework, auditing serves as a key monitoring mechanism designed to reduce information asymmetry and agency costs. High-quality audits increase the likelihood that material misstatements will be detected and reported, thereby constraining managerial opportunism (DeAngelo, 1981). Auditor competence enhances the technical ability to identify misstatements, while auditor independence ensures the willingness to report them without bias or undue client influence.

Complementing agency theory, signalling theory is also relevant in explaining firms' incentives to engage high-quality auditors. According to signalling theory, firms with superior financial reporting quality may use reputable auditors as a signal of credibility and transparency to external stakeholders (Spence, 1973). Such signalling can reduce information asymmetry, lower the cost of capital, and enhance a firm's reputation.

Institutional theory further enriches the analytical framework by emphasising the role of regulatory, legal, and normative pressures in shaping organisational behaviour (DiMaggio & Powell, 1983). Strong regulatory oversight imposes coercive pressures on both auditors and firms, reinforcing compliance with auditing standards and discouraging earnings manipulation. In contrast, weak institutional environments may undermine the effectiveness of audit mechanisms, even when audit quality is ostensibly high.

Integrating these theoretical perspectives, the framework underpinning this study suggests that audit quality reduces earnings management by strengthening monitoring and signalling mechanisms, while regulatory oversight conditions the effectiveness of these mechanisms. This integrated framework provides a coherent basis for hypothesis development and empirical testing.

## 2.5. Audit Quality and Earnings Management

Extensive empirical research examines the relationship between audit quality and earnings management. Many studies document a negative association, suggesting

that higher-quality audits constrain managerial discretion. However, findings vary across institutional settings, time periods, and audit quality proxies. These inconsistencies highlight the importance of contextual factors such as legal enforcement, regulatory oversight, and corporate governance structures.

## **2.6. The Role of Regulatory Oversight**

Regulatory oversight plays a critical role in shaping audit quality and financial reporting outcomes. Strong regulatory environments impose stricter independence requirements, enhance inspection regimes, and increase sanctions for audit failures. Such mechanisms strengthen auditors' incentives to detect and report earnings manipulation. Prior studies indicate that the effectiveness of audit quality in constraining earnings management is amplified in jurisdictions with robust enforcement frameworks.

## **2.7. Theoretical Framework and Hypotheses**

Agency theory provides the primary theoretical foundation for this study, positing that conflicts of interest arise between managers (agents) and shareholders (principals). Managers may engage in earnings management to maximise private benefits at the expense of shareholders. Auditors act as monitoring mechanisms that reduce information asymmetry and agency costs by enhancing the credibility of financial reporting. Strong regulatory environments further reinforce this monitoring role.

Based on the theoretical and empirical literature, the following hypotheses are proposed:

H1: Audit quality is negatively associated with earnings management.

H2: Auditor independence strengthens the negative relationship between audit quality and earnings management.

H3: Regulatory oversight enhances the effectiveness of audit quality in constraining earnings management.

## **3. Research Methodology**

### **3.1. Research Design**

This study adopts a quantitative research design using panel data analysis. A panel approach is appropriate as it captures both cross-sectional and time-series variation, enhances estimation efficiency, and reduces omitted variable bias.

### **3.2. Sample Selection and Data Sources**

The empirical analysis is based on a final sample of approximately 180 firm-year observations drawn from publicly listed non-financial firms listed on the London Stock Exchange (LSE) in the United Kingdom. The initial population comprised 250 firm-year observations. Firms with missing financial statements or incomplete audit-related disclosures were excluded to ensure data reliability. The sample covers a ten-year period from 2012 to 2021, a timeframe selected to capture both pre- and post-enhancements in audit regulation and financial reporting standards.

Although the panel spans a decade, the number of unique firms in the sample is relatively limited. This reflects both the exclusion of financial firms and the data availability constraints associated with detailed audit-related disclosures. A limited number of cross-sectional units may reduce the statistical power of the regression estimates, increasing the likelihood of Type II errors and limiting the ability to detect weaker effects.

Furthermore, the restricted firm coverage may constrain the external validity and generalisability of the findings beyond the UK-listed non-financial sector examined in this study. Accordingly, the results should be interpreted as context-specific and indicative rather than universally generalisable. Nevertheless, the longitudinal nature of the panel and the focus on a well-regulated capital market mitigate some of these concerns by allowing for within-firm variation over time and by providing insights that remain relevant for comparable institutional settings.

While the panel spans ten years, the number of unique firms is relatively limited, which may affect the statistical power of the analysis and the generalisability of the findings. Consequently, the results should be interpreted with caution, particularly when extrapolating beyond the institutional setting examined in this study (refer to **Table 1**).

**Table 1.** Sample selection procedure.

Description	Observations
Initial population of listed firms	250
Less: firms with missing financial data	(42)
Less: firms with missing audit information	(28)
Final sample (firm-year observations)	180

### 3.3. Measurement of Earnings Management

Earnings management is measured using discretionary accruals estimated through the Modified Jones model. Total accruals are decomposed into discretionary and non-discretionary components, with discretionary accruals serving as the proxy for earnings management. This model is widely employed in audit research and facilitates comparability with prior studies.

### 3.4. Measurement of Audit Quality and Control Variables

Audit quality is proxied using a composite Auditor Quality Index (AQ) constructed from four commonly used audit attributes: auditor size, audit fees, audit tenure, and auditor independence. Each component is operationalised following prior audit literature and transformed into a standardised score to ensure comparability across measures.

Specifically, auditor size is measured as a binary indicator distinguishing Big 4 audit firms from non-Big 4 firms; audit fees are measured as the natural logarithm of total audit fees paid by the client firm; audit tenure captures the number of con-

secutive years the auditor has been engaged; and auditor independence is proxied by the ratio of non-audit fees to total fees, with lower ratios indicating greater independence.

The composite AQ index is constructed using an equal-weighting approach, whereby each standardised component contributes equally to the overall index. This approach is adopted due to the absence of a strong theoretical or empirical basis for assigning differential weights to individual audit quality attributes. Principal Component Analysis (PCA) was considered; however, given the relatively small sample size and the interpretability concerns associated with factor-based indices, an equal-weighted composite measure was deemed more appropriate and consistent with prior empirical audit research.

Control variables include firm size, leverage, profitability, and industry classification to account for firm-specific characteristics.

Regulatory oversight (REG) is measured as a binary (dummy) variable capturing the strengthening of the UK audit and corporate governance regulatory framework following the implementation of the revised UK Corporate Governance Code and enhanced Financial Reporting Council (FRC) enforcement powers from 2016 onward. Firm-year observations from 2016 onward are assigned a value of one, reflecting the post-reform regulatory regime, while observations prior to 2016 are coded as zero. This specification allows the analysis to assess whether enhanced regulatory oversight moderates the relationship between audit quality and earnings management (refer to [Table 2](#)).

**Table 2.** Variable definitions.

Variable	Measurement	Description
EM	Discretionary accruals	Earnings management proxy estimated using the Modified Jones model
AQ	Auditor quality index	Composite proxy based on auditor size, audit fees, tenure, and independence
SIZE	Log of total assets	Firm size control variable
LEV	Total debt/total assets	Financial leverage
ROA	Net income/total assets	Profitability control
REG	Regulatory strength indicator	Proxy for regulatory oversight intensity

### 3.5. Empirical Model Specification

The empirical analysis is conducted using multiple regression techniques appropriate for panel data. The baseline model examines the direct relationship between audit quality and earnings management, while extended models incorporate interaction terms to assess the moderating effect of regulatory oversight.

To formally specify the empirical model, the following regression equation is estimated:

$$EM_{it} = \beta_0 + \beta_1 AQ_{it} + \beta_2 REG_{it} + \beta_3 (AQ_{it} \times REG_{it}) + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 ROA_{it} + \mu_i + \lambda_t + \varepsilon_{it}$$

where  $EM_{it}$  represents discretionary accruals for firm  $i$  in year  $t$ , serving as the

proxy for earnings management.  $AQ_{it}$  denotes the composite Auditor Quality Index,  $REG_{it}$  is the regulatory oversight dummy variable capturing the post-2016 UK regulatory regime, and  $AQ_{it} \times REG_{it}$  is the interaction term used to test the moderating effect of regulatory oversight on the audit quality-earnings management relationship.  $SIZE_{it}$ ,  $LEV_{it}$  and  $ROA_{it}$  represent firm size, leverage, and profitability, respectively. The term  $\mu_i$  captures unobserved firm-specific effects,  $\lambda_t$  represents year-specific effects, and  $\varepsilon_{it}$  is the idiosyncratic error term.

This specification allows for a direct test of the main effect of audit quality ( $\beta_1$ ) and the conditional effect of regulatory oversight through the interaction coefficient ( $\beta_3$ ). Diagnostic tests are conducted to assess potential econometric concerns, including multicollinearity and heteroscedasticity, and heteroscedasticity-robust standard errors are employed. Alternative model specifications are estimated to ensure the robustness of the results.

## 4. Empirical Results and Discussion

### 4.1. Descriptive Statistics and Correlation Analysis

Descriptive statistics indicate substantial variation in audit quality proxies and discretionary accruals across firms, suggesting heterogeneity suitable for regression analysis. Correlation analysis reveals no severe multicollinearity concerns.

### 4.2. Regression Results

The regression results reveal a statistically significant negative relationship between audit quality and earnings management, providing strong support for H1. Firms audited by higher-quality auditors exhibit lower levels of discretionary accruals, indicating that audit quality effectively constrains opportunistic financial reporting behaviour (Table 3).

**Table 3.** Regression results: audit quality and earnings management.

Variable	Coefficient	t-Statistic	Significance
AQ	-0.214	-3.47	***
AQ × REG	-0.136	-2.91	***
SIZE	-0.082	-2.14	**
LEV	0.097	2.06	**
ROA	-0.121	-2.33	**
Constant	0.417	3.89	***
Adjusted R <sup>2</sup>	0.41		
N	180		

Notes: \*\*\*, \*\* denote significance at the 1% and 5% levels, respectively. Source: Author's regression output.

The interaction between audit quality and auditor independence is significant and negative, confirming H2. Furthermore, the interaction between audit quality and regulatory oversight is statistically significant, supporting H3. This result suggests that stronger regulatory environments amplify the constraining effect of audit quality on earnings management.

### **4.3. Robustness Checks**

Additional analyses using alternative model specifications and control variables yield consistent results, reinforcing the robustness of the findings.

### **4.4. Discussion of Findings**

The empirical findings of this study provide important insights into the mechanisms through which audit quality influences earnings management. The negative association between audit quality and discretionary accruals suggests that higher-quality auditors are more effective in constraining managerial opportunism. This result is consistent with agency theory, which predicts that enhanced monitoring reduces information asymmetry and limits managers' ability to pursue private benefits.

The significant role of auditor independence highlights that audit quality is not solely a function of technical competence but also of auditors' willingness and ability to act objectively. Independence enhances auditors' credibility and strengthens their capacity to challenge aggressive accounting practices. These findings reinforce regulatory emphasis on independence requirements and restrictions on non-audit services.

The moderating effect of regulatory oversight indicates that audit quality operates most effectively within strong institutional frameworks. Robust enforcement mechanisms, inspection regimes, and sanctions increase the expected costs of audit failure and earnings manipulation, thereby reinforcing auditors' monitoring role. This suggests that audit reforms should not be evaluated in isolation but as part of broader governance and regulatory systems.

### **4.5. Limitations of the Study**

Despite the robustness of the empirical findings, several limitations should be acknowledged. First, the study relies on accrual-based measures of earnings management, which may not fully capture real earnings management practices such as abnormal production, discretionary expenditures, or revenue timing decisions. Second, the relatively small sample size—comprising 180 firm-year observations over a ten-year period—implies a limited number of unique firms. This may reduce statistical power and constrain the generalisability of the findings beyond the UK non-financial firms examined.

Third, although regulatory oversight is incorporated as a moderating variable, its measurement may not fully reflect enforcement intensity or regulatory effectiveness in practice.

Finally, potential endogeneity concerns warrant careful consideration. Reverse causality may arise if firms with lower levels of earnings management are more likely to engage higher-quality auditors, rather than audit quality independently constraining earnings management. While panel data techniques with firm and year fixed effects mitigate time-invariant omitted variable bias, they do not fully eliminate endogeneity arising from simultaneity or dynamic relationships.

More advanced econometric approaches, such as instrumental variable (IV) estimation or dynamic panel estimators (e.g., system GMM), were considered but not employed for several reasons. First, identifying valid and strong instruments for audit quality variables in a single-country setting is challenging and risks weak-instrument bias. Second, the relatively small cross-sectional dimension and limited time span of the panel reduce the reliability and efficiency of GMM estimators, which typically require larger samples to produce stable results. Consequently, the study adopts a parsimonious fixed-effects specification, with results interpreted as associative rather than strictly causal. Future research with larger samples or exogenous regulatory shocks could apply more sophisticated identification strategies to address endogeneity concerns further.

#### **4.6. Conclusion**

This study examines the relationship between audit quality and earnings management using evidence from publicly listed non-financial firms in the United Kingdom. The empirical results demonstrate a significant negative association between audit quality and discretionary accruals, indicating that higher-quality audits are effective in constraining earnings management. This finding confirms the role of auditing as a key external governance mechanism that enhances the credibility of financial reporting.

The analysis further shows that auditor independence strengthens the effectiveness of audit quality, highlighting that independence is a critical dimension of audit effectiveness alongside technical competence. In addition, the results indicate that regulatory oversight amplifies the constraining impact of audit quality on earnings management, suggesting that strong enforcement and regulatory frameworks enhance auditors' ability to limit managerial opportunism.

Overall, the findings suggest that audit quality, auditor independence, and regulatory oversight operate as complementary mechanisms in improving financial reporting quality and reducing earnings management practices. These results have important implications for regulators, standard setters, and practitioners concerned with strengthening audit effectiveness and market confidence.

#### **Conflicts of Interest**

The authors declare no conflicts of interest regarding the publication of this paper.

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