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Audit Quality and Earning's Management After the Implementation of Key Audit Matters – Jakarta's Public Accountants Perspective

Muhammad Fakhri[1], Fitriany[1]
[1]Universitas Indonesia, Jakarta, Indonesia

Corresponding author e-mail: muhammadfakhrie@gmail.com

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Abstract: The development of SA 701, and changes to SA 700, has led to a greater emphasis on "Key Audit Matters" (HAU) in the independent auditor's report. HAUs are the parts of the financial statements that are important and require more attention during the audit process. HAUs are considered to increase the transparency and usefulness of the auditor's report for stakeholders, as well as assist the auditor in communicating significant risk areas during the audit. This study aims to analyse the factors that influence audit quality, earnings management practices, and the impact of HAU implementation on audit reports in Indonesia. This research uses qualitative methods with direct interview data collection with public accountants in the area around DKI Jakarta. the results of this research found that material errors are considered crucial in audit quality. HAU-related changes help to reduce errors. Views on auditor independence influenced judgements on audits and compliance with auditing standards was key. The introduction of HAU is considered to increase transparency.

Keywords: Agency Conflicts, Audit Quality, Auditor Report, Earnings Management, Key Audit Matters

A. Introduction

Agency theory by (Jensen et al., 1986) assumes a conflict between management (agent) and majority shareholders due to information asymmetry. Management with more significant information allows them to exploit this information asymmetry for personal gain outside the company (Zeng et al., 2021). Agency problems would be minimised by a monitoring mechanism for management (Sai et al., 2024). Audit quality also receives special attention from stakeholders to reduce the risks involved (Alhadab & Clacher, 2018). The development of audit standards also allows audits to focus not only on interests and legal documents that may not be significant to majority shareholders, but also to ensure the usefulness and transparency of audit reports (Pratiwi et al., 2022). The International Auditing and Assurance Standards Board (IAASB) began developing ISA 701 in 2015. The Indonesian Institute of Certified Public Accountants (IAPI) issued SA 701 on Key Audit Matters in 2021. This standard requires the auditor to provide a description of significant audit matters, using appropriate subheadings, in a separate paragraph of the auditor's report entitled "Significant Audit Matters" (SA 701 - Paragraph 11). By applying Key Audit Matters, earnings management and other practices can be brought to the attention of stakeholders, and enhanced transparency can improve audit quality and reduce the likelihood of fraud by management (Sitanggang et al., 2022).

The main objective of an audit is to increase stakeholders' confidence in a company's financial statements, which can be ensured through an appropriate level of audit quality (Çetïn & Yaşar, 2021). Various stakeholders have different perspectives on audit quality as it is a complex and multi-faceted concept (Khader, 2023). Audit quality implies how well an audit is conducted, where the auditor should be able to detect and report material errors in the financial statements with integrity (Maijoor & Vanstraelen, 2006).

Audit Matters are important issues communicated by auditors in their audit reports. They represent areas in the financial statements that require the most attention during the audit process (Liemmuel & Eriandani, 2022). These issues are usually complex and subjective. Examples of Audit Matters include asset impairment, valuation of financial instruments, and revenue recognition in long-term contracts. The implementation of Audit Matters in the audit report is a requirement under International Standards on Auditing (ISAs) and aims to improve the transparency and usefulness of the audit report for stakeholders. By highlighting Audit Key Points, auditors provide insight into the key challenges and judgements made during the audit, helping financial statement users to better understand the financial reporting process and potential areas of risk.

Communication of Audit Matters in ISA 701 may guide stakeholder attention to important issues (Sirois et al., 2018). Increased attention from users of financial statements can be anticipated to potentially improve audit quality due to the adoption of Key Auditing Matters and reduce agency costs (Lin & Hwang, 2010). Communication of Key Audit Matters in the independent auditor's report in Indonesia became effective on 1 January 2022. There have been several studies in previous years describing the results of the adoption of Key Auditing Principles on audit quality and the likelihood of earnings management in countries such as the United States and the United Kingdom. However, there are still very few or almost no studies with the context of Key Auditing Issues in Jakarta or Indonesia.

On the basis of the problems outlined in the problem formulation, this study was conducted with the aim of analysing the effect and improvement of audited report quality on the implementation of Key Audit Matters, and analysing the effect of the implementation of Key Audit Matters on the impairment of earnings management.

Agency theory focuses on the relationship between principals (shareholders) and agents (management) as well as potential conflicts of interest that may arise between them (Botes et al., 2020). The primary audit issue can be thought of as a mechanism to mitigate agency issues by increasing the transparency and accountability of auditors and management to shareholders and other stakeholders (Wahab et al., 2023). The main audit aims to reduce information asymmetry by providing stakeholders with more detailed insights into significant issues faced by auditors during audits (Kusuma & Malau, 2023).

Key audit matters align with disclosure theory by enhancing disclosure of critical audit issues that may affect stakeholders' assessment of a company's performance and financial condition (Hu et al., 2022), (Hamzah et al., 2023). A major audit can be thought of as a form of assurance, giving stakeholders confidence that the auditor has thoroughly evaluated significant areas of the financial statements (Kristilestari & Andesto, 2023).

Key audit matters play an important role in improving audit quality. These are the important things identified by the auditor during the audit that require the highest attention and professional judgment (Wiratno et al., 2023). Different stakeholders will have different views again on audit quality because it is a complex and multifaceted concept (Kilgore et al., 2014).

By identifying and communicating key points in the audit, auditors focus their attention on the most critical areas in the financial statements. This ensures that audit efforts are directed at issues that have the most significant impact on the financial statements and are more proneto material error. Key audit matters contribute significantly to audit quality by directing auditors' attention to critical issues, increasing transparency, and providing valuable information to stakeholders about the audit process and its results. This increases the credibility and relevance of audit reports, which ultimately strengthens public confidence in financial reporting and the audit profession.

One recent study, (Cassell et al., 2015) examined the relationship between accrual-based profit management and transparency disclosure requirements to various activities on inventory assets, allowance for bad debts, and deferred tax assets. The authors found that companies engage less in profit management practices, when they need to be transparent as per disclosures required in association with their accounts. So, confirmation from external auditors adds transparency to the company's financial statements. The external auditor, as the gatekeeper, is responsible for validating the objectively analyzed financial statements according to IFRS.

In the research of (Preussner & Aschauer, 2022) it shows that the implementation of the main audit adds to the quality of audits in better and transparent communication. However, (Segal, 2019) Audit expert research sees that the main audit still fails to provide additional transparency in audited financial statements. (Su, 2022) research with an evaluation of 174 public accountants shows that auditors are easier to detect misrecords or errors that areclearly different from audit evidence compared to assessing fraud on a document that has been deliberately made. (Xuan, 2022) shows that stakeholders have not been able to obtain additional significant information and increase audit quality for the implementation of key audit matters.

Many past events have led to an increase in the functions, duties and responsibilities of auditors. Previous studies have found that there is a significant and positive relationship between audit independence and audit quality. (Xuan, 2022) posited that a bad audit would leave the door open for standard-compliant and illegal financial behavior. External audit is practiced because it can increase accountability in a professional manner and in the form of audit reports (An et al., 2023). Therefore, it is very significant to build good quality reports as auditors are responsible for the same.

B. Methods

This study applied thematic analysis techniques to explore and understand the data that had been obtained through the interview process. During the research process, the data collected from the interviews were recorded with the full consent of the participants. This step was crucial to ensure the reliability of the data, given that the entire process of thematic analysis relies on the codes generated from the information obtained in the interviews. With the permission of the participants, the interviews were recorded to ensure that every aspect of the themes and subthemes could be carefully analysed.

The in-depth interview approach in this study focussed on practitioners and auditors who are directly involved in audits, particularly in the context of major audits. This enabled the researcher to gain valuable insights and perspectives on audit quality and earnings management issues relating to the application of key audit matters. In this way, this research aims to unearth a deeper understanding of how changes in audit practice may affect practitioners who are at the forefront of audit work, as well as the implications for audit quality and earnings management.

These questions have been divided and grouped into three main groups, reflecting the in-depth research focus on views on the introduction of key audit matters in the new audit report and its implications, auditors' views on audit quality after the introduction of key audit matters and, views on earnings management. By taking a careful approach in designing the interview guidelines and by gaining insights from the respondents on these important aspects, this study aims to make a significant contribution to the understanding of the impact of HAU implementation on audit practice and earnings management.

The interviews were conducted in Jakarta, Indonesia. The interview participants were provided an invitation via email requesting their cooperation and support for the study. The email also included an introduction to the topic along with guidelines for conducting the interviews.

More than 25 auditors were initially contacted to participate in the interviews, however only 9 of them were willing and agreed to be interviewed. All interviews, whether conducted in person or via Google Meet, were conducted in 2023. On average, each interview session lasted about 40 minutes, which provided sufficient time to explore various issues related to audit quality and earnings management in accordance with the objectives of this study.

C. Results and Discussion

The interview analysis was conducted based on two main themes, namely Audit Quality and Profit Management, after the implementation of the HAU and changes to the auditor's report. Theresearch focuses on two central themes that form the basis for analyzing the results of interviews. The first theme is "Audit Quality," which refers to the evaluation and understanding of audit quality within the scope considered after the enactment of the HAU. The second theme is "Profit Management," which highlights issues related to profit management or possible actions taken by a company to manage its financial results in contexts involving HAU.

By examining interviews from the point of view of these two themes, this study aims to reveal the impact and relationship between the implementation of HAU with audit quality and profit management. The results of this analysis are expected to provide deeper insights into the changes that occurred in auditing and profit management practices after the implementation of HAU, as well as how this affects various aspects in the context of the company and accounting.

The factors that influence audit quality

Kualitas audit merujuk pada sejauh mana suatu audit memberikan assurance yang memadai mengenai keandalan laporan keuangan suatu entitas. Beberapa faktor yang dapat mempengaruhi kualitas audit meliputi

Integrity and Independence Auditor

Auditor integrity and independence is one of the keys to ensuring audits are carried out objectively. Auditors who are not tied to the entity being audited can have more freedom to identify and report audit findings honestly.

Auditor Competency and Professionalism

The level of competence and professionalism of auditors greatly influences audit quality. Auditors who are well trained, have adequate knowledge, and follow applicable audit standards can provide more accurate audit results.

External Pressure and Influence

External pressures and influences, such as from management or other stakeholders, may affect the auditor's independence and ability to conduct audits with purpose.

Risk Audit

The level of risk identified in an audit can influence the strategy and scope of the audit. Auditors must be able to identify potential risks well and plan audits taking these risks into account.

Audit Standards and Professional Ethics

Compliance with the standards and ethics of the audit profession is very important. Auditors who comply with applicable audit standards and uphold professional ethics will tend to provide more accurate and objective audit reports.

Audited Entity Management Quality

The quality of the management entity being audited can affect the quality of the financial statements and, indirectly, the quality of the audit. Management that is transparent, has good internal controls, and is committed to accountability can make it easier for auditors to carry out their activities.

Complexity and Characteristics of the Audited Entity

Entities that are complex or have certain characteristics, such as international businesses or certain industrial sectors, require special handling and careful audit planning to ensure good audit quality.

Audit and Corporate Governance Committee

The existence and effectiveness of the audit committee and overall corporate governance can influence audit quality. The role of an effective audit committee can help ensure auditor independence and a good understanding of risks.

Auditor's View of Risk and Materiality

The auditor's view of risk and materiality can influence the way the audit is conducted. Decisions about the extent to which risks are identified and how materiality is measured can influence audit results.

Use of Technology and Innovation in Auditing

The use of sophisticated audit technology can increase audit efficiency and effectiveness. Auditors who utilize data analysis tools, artificial intelligence, and other technological innovations can provide more accurate and in-depth reports. Shifts in audit quality involve a combination of various factors and it is important for auditors to pay attention to all aspects that can affect the independence, objectivity and thoroughness of audit results.

The factors influence earnings management practices

Memahami faktor-faktor ini membantu analis keuangan, auditor, dan regulator untuk mengidentifikasi potensi praktik manajemen laba dan mengambil tindakan yang sesuai untuk memastikan transparansi dan akuntabilitas dalam pelaporan keuangan. Adapun faktor-faktor yang mempengaruhi praktik manajemen laba sebagai berikut;

Managerial Incentives

Managerial incentive systems, such as bonuses and stock options, can encourage management to carry out earnings management in order to achieve financial targets or maximize their compensation.

Market Pressure and Investor Expectations

Companies often feel pressured to meet market and investor expectations. Management may engage in earnings management to avoid negative reactions from financial markets or stakeholders.

Accounting Regulations and Standards

Regulatory conditions and accounting standards can provide opportunities or limitations on earnings management practices. Some regulations can influence accounting policies that can be manipulated to manage earnings.

Fulfillment of Shareholder Needs

Management may want to meet shareholder expectations and provide a positive image of the company's performance in order to maintain or increase share prices.

Economic and Industrial Conditions

Overall economic conditions and within a particular industry can influence earnings management practices. Companies may tend to carry out earnings management when facing economic pressure or high competition.

Bankruptcy Risk

Companies facing the risk of bankruptcy or financial distress may be inclined to engage in earnings management to improve their image of financial health and gain better access to capital markets or financing.

Business Uncertainty

The level of business uncertainty, including market fluctuations or regulatory changes, can encourage management to manage earnings to create stability and positive perceptions among stakeholders.

Weak Monitoring and Supervision

Lack of internal or external supervision and monitoring can provide opportunities for management to carry out earnings management without detection.

Signaling and Agency Theory

Management can carry out earnings management as a positive signal to investors or to influence agency agents' perceptions of company performance.

Changes in Management or Shareholders

Companies that experience management changes or changes in share ownership may experience changes in earnings management practices in accordance with new stakeholder preferences and goals.

Company Characteristics

Factors such as company size, ownership structure, and company life cycle can influence earnings management practices. Smaller companies or those still in the growth phase may have different incentives for earnings management.

The impact of HAU implementation on audit reports in Indonesia

It is important to remember that the implementation of audit quality and earnings management is not only the responsibility of public accountants, but also involves close collaboration with company management. With synergy between public accountants and management, the positive impact can be felt more strongly in supporting the growth and sustainability of companies in Jakarta. The impact of implementing audit quality and earnings management after implementing key audit matters can have several important implications, including:

Increasing the Reliability of Financial Reports

Implementing good audit quality practices can increase the reliability of financial reports. Public accountants who are careful in carrying out audits can help ensure that the information presented in financial reports reflects the actual financial position.

Trust from Stakeholders

By ensuring high audit quality, public accountants can increase the trust of stakeholders, including investors, creditors and shareholders. This can strengthen the company's position in the eyes of the market.

Detection of Earnings Management Practices

Good audit quality can help detect inappropriate earnings management practices. Careful public accountants can spot signs or anomalies that indicate attempts to manipulate financial statements.

Increased Corporate Accountability

By implementing key audit matters, companies can increase their level of accountability. Public accountants can act as independent custodians who help ensure companies comply with applicable standards and regulations.

Business Sustainability

Implementing good audit quality practices and strict control over earnings management can help companies build long-term business sustainability. This sustainability can provide competitive advantages and maintain the company's reputation.

Better Understanding of Business Risks

Public accountants who deeply understand the business and economic environment in Jakarta can help companies identify business risks that can affect financial statements. This can provide additional benefits in planning and managing risk.

Compliance with Local Regulations

Public accountants who understand local business rules and regulations in Jakarta can help companies ensure their compliance. This can prevent sanctions or other negative consequences that may arise due to regulatory violations.

Professional Reputation

Implementing high quality audit practices can improve the reputation of public accountants in Jakarta. This can be attractive to potential clients and strengthen the position in the market.

Increased Operational Efficiency

Through the implementation of key audit matters, companies can improve their operational efficiency. An effective audit process can help reduce the costs and time involved in preparing financial statements.

Understanding Business Trends

An actively involved public accountant can provide insight into local and global business trends. This can help companies understand changes in the business environment and respond to them better.

In this study, the researcher explores the factors that concern the interviewees in the context of audit quality. The research appendix contains a list of questions relating to KAM and Audit Quality. Analysing the responses to these questions enabled the researcher to identify in-depth sub-themes within the theme of 'Audit Quality'. Classifying this main theme into five sub-themes, each of which describes relevant aspects in the context of audit quality. The sub-themes include Material Misstatement, which relates to important misstatements in financial statements, Objectivity, which refers to independence and fairness in the audit process, Standards Compliance, which highlights adherence to audit guidelines and regulations, Transparency and Communication, which emphasises the importance of clear information and effective communication in audits, and Future Challenges, which details the changes and issues faced in the development of auditing. By exploring the views of the interviewees and analysing their responses to the questions posed, this research aims to understand and detail the various aspects that affect audit quality, thus providing a deeper and more comprehensive insight into the field.

The risk of pervasive errors or the impact of spreading to all parts of the financial statements itself is one of the risks that become a leaning point for the implementation of financial statement audits.

In the early stages of this research, participants were invited to formulate a definition of audit quality based on their own understanding. This approach aimed to explore their views and perspectives on the matter, as well as to gain an initial understanding of how they measure quality in the audit context.

The results of these initial interviews highlighted the importance of material errors in the understanding of audit quality according to the interviewees. Interviewees, such as 001 002, 007 and almost all interviewees emphasised that audit quality involves presenting a report that is free of material errors. They also highlighted the importance of awareness of assessed risks in determining the content of the audit report. In addition, they highlighted the aspect of independence in the review and certification of the report by qualified auditors as a factor that increases the trustworthiness of the report, especially for various interested parties.

In practice, an unbiased opinion is the result of an audit that reflects the auditor's findings based on facts and evidence found during the audit, rather than due to pressure or particular preference. It provides confidence to interested parties, such as shareholders, creditors, and regulators, that the audit report is a fair and accurate representation of the finances or operations of the entity being audited. Objectivity in audit practice can be an important consideration, especially when comparing large audit firms (Big 4) with smaller or non-Big 4 audit firms. However, keep in mind that every audit firm, whether large or small, must adhere to the same ethical standards and auditing practices.

Objectivity in auditing is a fundamental principle that must be upheld by an auditor. This refers to the quality of an audit that must be free from personal influence or bias, and must be based on objective facts and evidence. In the context of auditing, objectivity means that the auditor must perform his duties with impartial discretion and not allow personal preferences or external pressures to influence the results of the audit. This is important because objectivity is one of the key factors that determine the reliability of audit reports.

All participants were of the opinion that compliance with auditing standards is the main requirement for a quality audit. Compliance with standards, both auditing standards and applicable financial accounting standards, is also one way for auditors to maintain the quality of each audited financial report and maintain the suitability of audit quality in each financial report. For example, interviewee 005 believes that "Audit quality is based on compliance with standards along with complementary factors such as auditor knowledge, skills, experience, and scepticism." Interviewee 006 also stated that "established audit procedures are one way for auditors to maintain the quality of financial statements that are compliant and in accordance with applicable accounting standards".

An objective audit will result in an unbiased opinion. An unbiased opinion in an audit is a judgement or opinion given by the auditor after objectively evaluating the entity or transaction. In this context, "unbiased" means that auditors have no conflicts of interest that could affect their judgement. They must maintain independence and impartiality in the audit process.

Objectivity in audit practice can be an important consideration, especially when comparing large audit firms (Big 4) with smaller or non-Big 4 audit firms. However, keep in mind that every audit firm, whether large or small, must adhere to the same ethical standards and auditing practices.

Participant 001 commented: "It is undeniable that the auditor's fee will affect the quality of the audit and may affect the work scoop of the auditor, and there is still an imbalance in performance both from the number of employees, how much can be disbursed, and the time of the engagement on Big 4 and non-Big 4 KAP".

Participant 003 commented: "As someone who has worked in non-Big 4 and Big 4 public accountants, differences in the number of employees, engagement fees, and preparation and execution time for each engagement will definitely affect the quality of audits and how interactions between auditors and clients occur"

HAU helps report readers, such as shareholders and other interested parties, to understand the most influential aspects of auditing. This creates more transparent reports, outlines more detail about auditors' assessments and allows stakeholders to make more informed and knowledge-based decisions. Along with the increasing demand for transparency and accountability in auditing, the introduction of HAU has become a positive development in the effort to achieve a more quality and informative audit report. Participants' understanding of the benefits of HAU in improving communication and transparency is important in shaping more effective audit practices and maintaining trust in the audit process.

A key challenge expressed by Non-Big Four auditors is that the implementation of HAU may have different impacts depending on the scale and type of entity being audited. For large companies listed on the stock exchange and operating in Indonesia, HAU can provide additional clarity and transparency in audit reports, which can help in identifying important issues affecting financial statements.

Profit management refers to the practices employed by entities or management in managing their profits or financial statements in a way that may affect the judgment of readers of financial statements, including auditors. Profit management is often used to improve an entity's financial image or to meet certain financial targets. However, excessive or unethical Profit Management can be detrimental to audit quality because it can lead to bias in the information evaluated by the auditor. Although basically the HAU section can be part of gatekeeping the company's business implementation and reduce profit management risks, there are still mixed views and there is no direct experience gained by the speakers. This reflects the complexity of this issue and the importance of auditors' professional judgment in determining how HAU can be used in a particular audit context. Overall, the effect of profit management on audit quality is an important issue in audit practice. Profit management, transparency, integrity, and ethics remain key focuses in maintaining high audit quality. Reforms and changes in audit practices can help maintain the quality of financial statements and strengthen stakeholder confidence in the audit process.

The existence of profit management not only undermines the quality of audits, but also increases agency costs where management manipulates profits for personal gain. In current practice, profit management is carried out by holding costs that may have been amortized but not recognized, or recognition of untimely or unsustainable revenue with costs that may also have been incurred.

In practice, although auditors are required to be independent and carry out their work professionally, along with the course of engagement and audits of financial statements that may repeat several years will inevitably create a relationship between auditors and management, this may be one of the threats or conflicts of interest if auditors cannot maintain their integrity and competence. Pressure from the client itself is very likely to occur if the auditor has a certain closeness to the client / management of a company.

From the results of the interview, it is known that there is no implicit direct pressure by public accounting firms to auditors to do non-procedural things and things that may affect / have an impact on the quality of an auditor's report.

D. Conclusion

Audit quality becomes a reference to how reliable a financial report is, the more reliable and trustworthy the quality of the report of each public accountant or public accounting firm will be a measure of how fair the financial statements are. The implementation of the main audit matters on changes to SA 701 and changes to SA 700 revision 2021 itself has a big influence on the way auditors carry out work on each audit engagement. All interviewees agreed that material misstatement is an important factor in assessing audit quality, and the changes to the auditor's report and the introduction of HAU have led to the examination and reduction of material misstatement. When participants were asked about their views on auditor independence in the audit process, it was identified that participants. These factors may limit auditors from Non-Big Four firms in providing their judgement in various HAUs. While the opinions of the Non-Big Four were not in favour of HAU implementation, auditors from the Big Four were in favour of HAU for auditor objectivity. The level of transparency and communication was enquired after the introduction of HAU. All Big Four and Non-Big Four participants believe that it is an excellent initiative to illustrate all key issues to users of listed companies. The implementation of the HAU section is still considered rudimentary and stakeholders have not seen the direct benefits of the key audit matters section in the auditor's report. However, the process of collecting audit evidence is one of the best ways for auditors to obtain information that will be able to support the opinions they issue, they ensure that they will not be involved in attempts to cover up anomalies or unauthorised practices in the financial statements. Earnings management being one of the risks of material financial statement errors, "excessive" earnings management not only provides significant misinformation and impacts the decision making of the board of directors or top management. Audit procedures have generally been able to reduce the risk of earnings management that may be inconsistent with the evidence collected during the audit engagement process.

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