

Firm Size, Auditor Type, and Earnings Management

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Abstract

This paper investigates how firm size and auditor type affect earnings management to avoid losses. Firm size is a proxy for the information asymmetry between managers and investors in the predisclosure information environments, as managers of small firms are able to retain their private information more successfully than their counterparts of large firms. On the other hand, auditor type refers to the effectiveness of a firm's monitoring function in preparing and issuing financial statements, as firms with Big Six auditors are expected to issue more reliable financial statements than their counterparts with non-Big Six auditors. Accordingly, other things being equal, small-sized firms or firms with non-Big auditors are expected to more frequently manipulate earnings to avoid losses.

Our findings show that small firms tend to more frequently manage earnings to avoid losses than do large firms; and firms with non-Big Six auditors appear to more frequently manage earnings to avoid losses than do their counterparts with Big Six auditors. When firm size is controlled, auditor type is not a significant factor in explaining the cross-sectional variation of earnings management to avoid losses. Thus, firm size, not auditor type, appears to play a primary role in discriminating between firms that do and don't manage earnings to avoid losses.