



INTERPLAY BETWEEN ACCOUNTING CONSERVATISM, AUDITING CONSERVATISM AND QUALITY OF EARNINGS IN OMAN

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ABSTRACT

This paper examines the impact of accounting conservatism and auditing conservatism on earnings quality. Four proxies were used to measure earnings quality; persistence, accrual quality, value relevance and earnings smoothness. We use the published annual reports of all the listed firms in the Muscat Securities Market (MSM) for the 6-year period from 2012-2017 to assess the interplay between accounting conservatism, auditing conservatism and earnings quality. The result reveals a positive and significant effect of auditing conservatism on earnings quality but no significant effect of accounting conservatism on earnings quality in terms earnings smoothness. This implies users tend to rely on auditors' reports when assessing earnings quality. Our results are robust to the inclusion of four control variables; size of the firm, risk, audit firm size and industry type, the use of an additional analysis of one special case of auditing conservatism and earnings quality, and tests of potential relationship between auditing conservatism. The findings have implications to regulators when formulating standards and guidelines, auditors in the course of an audit, investors in reviewing the financial statements, and preparers when preparing their financial reports. The study recommends that Omani stockholders as well as international stockholders rely heavily on auditing conservatism which means that stockholders are prepared to receive modified audit reports.

JEL Classification: M21, M41, M42, G31

Key words: Accounting conservatism, Auditing conservatism, Quality of earnings, Oman, Emerging economy

1. INTRODUCTION

This paper assesses the interplay between accounting conservatism (AC) and auditing conservatism (AuC) on earnings quality (EQ). Basu (1997) defines AC as a higher degree of verification for recognizing good news for earnings and assets, while Vishnani and Misra (2016, 1002) expand the definition by adding the “recognition of expenses and liabilities prudently, even if there is uncertainty about the outcome, incomes and assets are recognized only when there is full surety of receiving them”. In short, AC is an accounting process whereby preparers of financial statements have considered and included all the possible uncertainties and risks when estimating and reporting them in the financial statements. AuC is the extent of conservatism that auditors apply to their audit approaches in compliance with regulations and guidelines when assessing reliability and relevance of information and estimations, and when reporting material accounting departure and limitations on the scope of completing an audit. Earnings quality (EQ) is the extent of reliability of a firm’s reported earnings. Reliability of EQ depends on the extent of disclosing material information in the financial statements, compliance with regulatory requirements and meeting user needs. Put together, accounting conservatism depends on the extent preparers measure and report the financial items, while auditing conservatism depends on the extent auditors exercise reservations and skepticism during audits. These two conservatisms, in totality or individually, could impact on the fair presentations of earnings quality in financial statements.

Because of information asymmetry between preparers responsible for measuring and reporting the financial details and stockholders who are recipients of financial reports, auditors serve as agents to ensure preparers exercise conservatism in their estimations and transparency in disclosing financial details. This means that accounting conservatism and audit conservatism contribute to earnings quality. In practice, however, there is possible disparity between the interplay among the three variables. Preparers tend to project a better financial performance in a particular quarter for keeping the earnings trend by adopting different accounting choices in their estimations. The intention is to smooth the income figures. Though not ethically appropriate, the intention is to

maintain the firm's profile on income predictions, profitability, returns and growth to avoid unnecessary divestments and market reactions (Chong, 2006). The process will involve either preparers compromising their conservatism in exercising their measuring and reporting obligations, or auditors in relaxing their audit conservatism, or both parties working in tandem to compromise their responsibilities for the firms' long term growth and survival.

Prior findings tend to use either AC or AuC as a single variable to assess the effects on EQ, but the results remain mixed. Further, there is no known study evaluating the coexistence of AC and AuC on the impact of a firm's EQ. We fill this gap by using both AC and AuC to assess EQ and the interplay between AC and AuC on EQ of the published financial reports of all the firms listed in the Muscat Securities Market (MSM) for the 6-year period from 2012-2017. Before 2012, more than 90% of audit reports of Omani companies were unmodified as the auditors stated that the company financial statements are presented fairly in all material aspects according to the international financial reporting standards and other adopted rules and regulations. This means that neither AC nor AuC are presented in the financial reports of Omani listed companies. After that, some amendments in the Code of Corporate governance were introduced by the Capital Market authority (CMA). These amendments gave the CMA more power to control audit firms; then CMA started to examine output of these audit firms and estimate the litigation potential for them. One of the most important changes of this new situation is that the AuC is introduced in the audit reports and most of these reports have changed into modified audit reports.

The result of this study reveals AC does not have any significant effect on EQ, but AuC has a significant impact on EQ. This implies Omani stockholders tend to rely on auditors' conservatism more than accounting conservatism, reflecting the extent of agency relationships between auditors who serve as agents and investors who are principals of the audit contracts, and the returns on quasi rents that the principals have paid for the audit services. Though the results of this study solely come from the Omani perspective, the findings have significant implications to regulators, preparers, auditors and the stockholder investors both within the country, and outside the region and around the world. We organize the study as follows. Section two reviews the Omani perspective while section three reviews relevant literature and develops the hypotheses concerning the association between accounting conservatism,

auditing conservatism and earnings quality. Section four presents the research method, sample selection and variables definitions. Section five discusses the empirical analysis and results. Section six concludes the paper, besides discussing the limitations and suggesting avenues for future research.

2. THE OMANI PERSPECTIVE

Though auditing plays a crucial role in financial statement credibility, the government agencies that publish accounting standards and auditing guidelines have yet to exercise their judicial duties in monitoring performance of those not meeting the stipulated requirements. In Oman, the Ministry of Commerce and Industry (MoCI) is responsible for publishing the accounting standards and the Capital Market Authority (CMA) is issuing the auditing guidelines. Preparers are expected to measure and report the firm's assets and liabilities, while auditors are required to ensure the financial statements present a fair picture on the valuation and disclosure of material items to the stockholders; accounting conservatism does not seem to exist, but audit conservatism does. The lopsided emphasis could be attributed to a lack of communication between MoCI and CMA, or could be due to a lack of heavy fines and penalties on defaulters. The Ministry itself may not have the skilled manpower for prosecuting those who failed to exercise the duties of care on accounting conservatism. Except for listed firms, the non-listed are not expected to comply with the International Standards of Accounting in measuring and reporting items in financial statements. So far, there are no known litigations on preparers who failed in the compliance process in Oman. Though in 2016, the Ministry has approved the formation of the Association of Chartered Accountants of Oman, an independent organization, to formulate and oversee the quality of assurance services, the OACPA merely serves as a professional body to organize exams for students to provide continuing professional education for its members. Apart from the Ministry and the professional body, auditors in Oman use the International Auditing Standards, the Commercial Company Law (Article 209, No. 18, 2019) and its amendments, the Accounting and Auditing law (Royal Decree No 77, 1986) and its amendments, and the Capital Market Authority (CMA) Code of Corporate Governance Regulation (2002) and its amendments for conducting audit assessments. These laws and amendments expect auditors to be independent, maintain high audit quality, be accountable and ethical

in their work, continue with their professional training and education and assess effectiveness of audit committees and internal control systems of the auditees. Nothing has been mentioned about how auditing conservatism should apply in practice or when reporting. As far as the auditing market is concerned, Article 209 of Omani Commercial Company Law number 18, 2019 requires all joint-stock and limited liability firms to be subject to external audits by a local or a foreign qualified and recognized auditor.

As at 2017, CMA and the Ministry have recognized 19 audit firms. These firms are categorized in 3 separate groups, namely Big 4 audit firms, non-big 4 audit firms and local audit firms. A non-Big 4 firm is a local practice that links to an international audit firm and has offices in various cities in Oman, while a local audit firm is a local practice not affiliated with any international audit firm. A typical local firm is mainly operated by a sole practitioner or a few local partners. By the end of 2017, 73% of the listed firms' financial statements were audited by the Big 4 while the remaining by the non-Big 4 audit firms (MSM Guide report, 2018); none was audited by a local audit firm. The market is dominated by the Big 4.

The Capital Market Authority has mandated that all listed firms must appoint external auditors, and audit firms themselves need to rotate the engagement partners every four years. Apart from providing assurance services, CMA allows audit firms to extend their non-audit services including assessing adequacy of internal control systems, taxation advisory, and investigations arising from an audit finding. All findings relating to audits and non-audit services should be reported directly to the audit committee for reviews and approvals before inclusion in the audit reports. Without the committees' consent, auditors are disallowed from including these weaknesses in their reports. To a certain extent, audit conservatism is being constrained by the clients' audit committees rather than auditors exercising their duties in reporting directly to the principals (Hegazy, Chong, and Hegazy, 2014). To a certain extent, the Omani auditors have lost their rights for servicing directly to the stockholders. External auditors are supposedly reporting to the stockholders who are the principals not the audit committees who are serving as an agent for the stockholders. The agency theory on the relationship between the external auditors and stockholders seems to fade away due to interceptions by the audit committees, who also serve as an agent of the stockholders. The Ministry needs to fix this issue to restore stockholder confidence in auditors' work.

With regard to market saturation, similar to many other emerging economies, most audits for listed firms are dominated either by Big 4 firms or local firms associated with an international firm. In Oman, the ratio of audit firms to the number of listed firms is 1:17 reflecting the extent of competition among audit firms to provide quality reports within short durations (Baatwah, 2016). With the market concentrations and a lack of accounting constraints on reporting directly to the stockholders, auditing conservatism remains an important issue.

Put together, earnings quality appears with high level of accounting conservatism and audit conservatism. In Oman, the weight of conservatism seems to rely on audit more than accounting though external auditors have the opportunity to express their concerns through audit committees. Auditors are only responsible for expressing opinion on the fairness in measuring and reporting the financial information; the bulk of measuring and reporting, and design and implementation of internal control systems should rest on the preparers. With these lop-sided interplay, we assess the extent of accounting conservatism and audit conservatism toward earnings quality in Oman, and the extent of audit willingness in compromising their audit conservatism in exchanging for earnings quality and accounting conservatism.

3. LITERATURE REVIEWS AND HYPOTHESES DEVELOPMENT

3.1 EARNINGS QUALITY

Preparers are expected to exercise conservatism when estimating liabilities and risks, and present a fair report to the stockholders. Essentially earnings quality depends on the extent of reliability, relevance, completeness and accuracy of the statements. Auditors are expected to exercise conservatism in assessing the information presented by the preparers before attesting them. It is important that both preparers and auditors exert conservatism to ensure quality of earnings (EQ). Stockholders need a reliable source of financial information and earnings quality to make professional decisions in maximizing their investment returns and evaluating firm performance (Rajaram, Suganthi, and Chong, 2015). Dechow, Ge, and Schrand (2010) find that EQ serves as a function of a firm's performance, while both Nwaobia, Kwarbai, and Ogundajo (2016) and Jaballah, Yousefi, and Zarai (2014) conclude that there is a

positive and strong association between earnings quality and investors' decisions.

Though preparers use EQ to determine the choice of accounting to measure and report earnings, different stockholders may have different perspectives on EQs. Stockholders use EQ to determine a firm's investment decisions, financial analysts rely on EQ to assess its going concerns, profitability, predictability and growth, regulators ensure EQs were derived based on accounting standards and audit guidelines, while economists use EQ to evaluate the firm's real value of profit or economic profit. Though the bottom line remains the crucial factor in decision making, Dechow et al. (2010) caution that relying solely on EQ is meaningless. Pagalung and Sudibdyo (2012) suggest stockholders should assess EQ together with other variables including the nature and extent of inherent and control risk, and firm performance, age and size. Kamarudin and Ismail (2014) and An (2017) conclude that EQ should be measured based on both short term and long term sustainable returns. All these depend on the extent of both preparers' and auditors' willingness in exercising conservatism while discharging their duties of care. Positive interplay exists between AC, AuC and EQ and the duration of interplay between the three elements depends on internal factors including the extent of preparers in applying conservatism in their accounting policies, and external factors including to what extent external auditors apply conservatism in their audit approaches. Both accounting and auditing conservatism enhance quality of earnings.

Many proxies are used to measure earnings quality. Dechow et al. (2010) list and discuss many of these proxies such as persistence, accrual quality, timely loss recognition, smoothness, earnings surprise and benchmarks. Dechow et al. (2010) assert that using different EQ proxies is required to demonstrate different angles of earnings quality. For example, they explained that researchers should use various proxies of EQ because they do not work equally in all circumstances. The decision models of the decision-makers are also different, and thus using different proxies is critical to cover the majority of these models. A decision-maker can use earnings persistence as a proxy to evaluate earnings stability and value relevance to evaluate the usefulness of accounting information and reflect the variations in returns.

Considering availability of information in Oman, this study uses only four approaches. The first is the persistence of earnings which is receiving growing attention from researchers in developed

markets (Ebaid, 2011). Persistence means how much of existing profits will persist into the future and proceed from period to period (An, 2017). The slope β coefficient of earnings is used to measure persistence as a higher β implies a more persistent earnings stream. The logic behind this approach is that the existing earnings are indicators for future performance of the firm and the investors are very concerned with earnings sustainability where the value of β close to 1 indicates highly persistent earnings or sustainability, while value of β close to 0 represents highly transitory earnings (Richardson, 2003).

The second approach is accrual quality. The difference between accounting earnings and cash flows from operations refers to accrual quality. This approach focuses on the relationship between the earnings and cash flows from operating activities. Dechow and Dichev (2002, 38) defined accrual quality as the “extent to which accrual map into cash flow realizations where a poor match signifies low accrual quality”. They argue that earnings will be more representative of future cash flows when accruals contain lower estimation error as higher accruals quality is considered when accruals quickly convert into cash.

The third approach is smoothness of earnings. Smoothness is the ratio of standard deviation of net income divided by total assets to standard deviation of cash flow divided by total assets (Francis et al., 2004). A lower value indicates more smoothing of the earnings stream relative to cash flows and small value indicates good earnings quality (Dechow et al., 2010).

The fourth approach is value relevance which indicates the explanatory power of earnings and book value of equity for share returns. Value relevance is measured by using R^2 of earnings or book value of share returns as large (small) R^2 reflects more (less) value-relevant earnings (An, 2017). Despite the previous studies giving mixed results regarding value relevance of earnings, earnings per share and book value are common measures of earnings quality. Therefore, we will use R^2 of earnings or book value, whichever is higher, to reflect more value relevant earnings.

3.2 ACCOUNTING CONSERVATISM AND EARNINGS QUALITY

Basu (1997) defines accounting conservatism as an anticipation of no profit, but recognizes all foreseeable losses. Vishnani and Misra (2016, 1002) expand Basu’s (1997) definition by “recognizing expenses and liabilities prudently, even if there is uncertainty about

the outcome; but incomes and assets are recognized only when there is full surety of receiving them". This means, preparers of financial statements should be prudent in recognizing both revenues and assets, and expenses and liabilities, by exercising caution and certainty when measuring and recording items in financial statements. They should record only those realized assets and revenue, and recognize all foreseeable losses and liabilities. Preparers should exercise accounting conservatism in all situations. Hejranijamil et al. (2020) pointed out that AC has been demanded by many stakeholders such as investors, auditors and authorities in order to minimize agency costs by reducing information asymmetry and promoting corporate governance. Not only should preparers exercise AC but the financial analysts find that AC is an important factor in making good earnings forecast; Jung et al. (2017) indicate that incorporating AC into earnings forecasts of the analysts is an important reflection of analyst expertise and professional success.

In view of EQ being subject to estimations and uncertainty, Chi, Liu, and Wang (2009) find that conservatism is one of the most prominent characteristics of financial accounting that preparers are urged to be prudent in their accounting approach, in particular in situations where judgments such as depreciation calculations, accruals, and valuing slow-moving inventories are needed. Accounting conservatism is not intended to manipulate the dollar amount or timing of reporting, but serves as a guidance to ensure preparers remain professional in situations or times of recognizing uncertainty and risk. According to Cerqueira and Pereira (2020) AC helps the firms to recover in periods of economic downturn and it is used as a governance mechanism to reduce managers' incentives to manipulate financial statements.

Watts (2003), Kim et al. (2013) and Zhong and Li (2017) explore the opportunistic behavior of managers on accounting conservatism and EQs, and they find a strong relationship between AC and EQ. They conclude that a positive relationship between AC and EQ leads to a significant reduction in agency costs on potential conflicts and misunderstandings between preparers and stockholders. A reduction in potential conflicts would lead to an increased level of trust. Preparers need to constantly exercise conservatism in preparing financial statements by complying with the underlying accounting policies and principles. Safdar and Yan (2016) and Chong (2006) find a positive relationship between income smoothing as an accounting conservatism practice and reported earnings. This

implies firms that use income smoothing have lower volatility in reporting earnings. Daryaei et al. (2020) assert that AC has impact on EQ as it enhances the value of firm cash flow. Shubita (2015) concluded that income smoothing improves EQ among the GCC countries. This shows income smoothing has a positive and significant impact on EQ. In Oman, all listed firms are required to prepare their financial statements in line with the IFRS guidelines on measuring and reporting financial items. The International Accounting Standards Board (IASB) argues that conservatism should not be one of the financial reporting characteristics since using conservatism against uncertainty will reduce the future orientation of financial information and relevance of information for decision making purposes. Andre, Filip, and Paugam, 2015; Zeghal and Lahmar (2016) and Cerqueira and Pereira (2020) find that those European firms that adopt the IFRS have reduced accounting conservatism. Since 2016, the Capital Market Authority (CMA) in Oman observed a reduction in litigation risks against preparers and auditors due to preparers being expected to comply with IFRS standards while auditors are expected to meet the International Auditing Standards requirements. The Corporate Governance (CG) Code has insisted that auditors assess the audit risks, thereby reducing the number of modified audit reports. Both accounting conservatism through CMA and auditing conservatism through the CG Code have impacted on the financial reporting and auditing environment in Oman. Transparency, accountability and the level of trust in measuring and reporting items, and the audit processes have contributed to quality of earnings. However, we could not ascertain that accounting conservatism is the main determinant for earnings quality in Oman.

As this study uses four proxies to measure EQ; earnings persistence, accrual quality, value relevance and earnings smoothness, the hypotheses of association between accounting conservatism, auditing conservatism and each proxy is discussed as follows:

3.2.1 ACCOUNTING CONSERVATISM AND EARNINGS PERSISTENCE

The main issue with respect to conservatism and earnings persistence is that the conservatism created asymmetric persistence in earnings. Basu (1997) asserts that more conservatism results in asymmetric persistence between good and bad news events as bad news events

are associated with less persistent earnings. In contrast, accounting conservatism in reporting may also be associated with increased earnings persistence. If the firms postpone the recognition for good news events in the current period due to conservatism, the increased earnings persistence will be more in the future periods. Mora and Walker (2015) find that asymmetric persistence in earnings will make earnings forecasting more difficult for analysts and investors. In the GAAP environment, Chen et al. (2014) and Heflin, Hsu, and Jin (2015) find that firms with more conservative accounting generate less persistent earnings than firms with less conservative accounting as accounting conservatism reduces GAAP earnings persistence. In the IFRS environment, such as Oman, prior studies (Zeghal and Lahmar, 2016; Andre et al. (2015); Preiato, Brown, and Tarca, 2015) reported that using of accounting conservatism is reduced because of IFRS indicating that accounting conservatism become less attractive and important and therefore the effect of it on earnings persistence is not expected. Also, Cerqueira and Pereira (2020) and Astuti (2020) assert that because IFRS adopts fair value accounting, accounting conservatism is reduced and omitted from the conceptual framework of IASB as the firms did not use it in financial reporting. Therefore, the hypothesis is:

H1: There is no association between accounting conservatism and earnings persistence.

3.2.2 ACCOUNTING CONSERVATISM AND ACCRUAL QUALITY

Dimitropoulos (2008) finds no association between accounting conservatism and accruals of earnings. Large positive accruals are a case when earnings are higher than cash flows generated by the firm indicating there is a difference between earnings and cash flow. The large accruals are caused by managers' decisions about magnitude and timeliness of disclosure of revenues and costs in financial statements. Accordingly, Dimitropoulos (2008) found that earnings accruals were not influenced by conservatism because they were generated according to the realization basis not cash flows basis. Ahn and Kwon (2010) examined the earnings persistence-market reaction association with respect to accruals and cash flows in Korea. They found that the Korean stock market has a high level of earnings persistence and this is more attributed to cash flows than accruals. Also, Soderstrom and Sun (2007), Fuad and Wijanarto (2017), Santy,

Tawakkal, and Pontoh (2016) and Brad et al. (2014) found positive impact of IFRS adoption on accounting quality. One of the important reasons for this positive impact is that IFRS limits discretionary behavior in earnings management because IFRS reduces the scope of conservatism. Therefore, the hypothesis is:

H2: There is no association between accounting conservatism and accrual quality.

3.2.3 ACCOUNTING CONSERVATISM AND VALUE RELEVANCE

Prior studies examining the association between accounting conservatism and value relevance have yielded mixed results. Manganaris, Floropoulos, and Smaragdi (2011) found negative association between accounting conservatism and value relevance indicating that more accounting conservatism is associated with less value relevance. Brown, He, and Teitel (2006) find that accounting conservatism reduces managers' opportunistic behavior, hence increasing the value relevance. Kousenidis, Ladas, and Negakis (2009) indicate that an association exists between accounting conservatism and value relevance of earnings. Hejranijamil et al. (2020) however find negative relationship between accounting conservatism and value relevance as value relevance rises. This has declined for those high-conservative firms. Balachandran and Mohanram (2011) find no evidence that firms with increasing accounting conservatism present greater declines in value relevance. They attribute the result to increase the importance of relevance and reliability as financial information characteristics which makes the trade-off between them very difficult. Therefore, the hypothesis is:

H3: There is no association between accounting conservatism and value relevance of earnings.

3.2.4 ACCOUNTING CONSERVATISM AND SMOOTHNESS

The main issue with earnings smoothness is that the manager uses it to reduce the earnings variability. Using the smoothness, earnings will be more representative, more useful and uncertainty about earnings will be eliminated (Francis et al., 2004). On the other hand, accounting conservatism improves the quality of accounting information by reducing manager optimistic behavior (Cerqueira and Pereira, 2020; Rostami, Rezaei, and Khalatbari, 2019; Hsu,

Novoselov, and Wang, 2017; Pashaki and Kheradyar, 2015; Lara, Osma, and Penalva, 2014). For example, Hsu et al. (2017) point out that firms exercising accounting conservatism show better cash flow performance. Also, Lara et al. (2014) found that accounting conservatism allows investors to make good assessment for future firm performance by reducing information asymmetries between managers and investors. Cerqueira and Pereira (2020) conclude that accounting conservatism is preferable because it is used to avoid violation of debt covenants and minimizes the risk of opportunistic payments in the form of compensation and dividends. Accordingly, both accounting conservatism and smoothness have the same incentives and direction as the firms use both to reduce optimism in financial statements.

In IFRS environments, Capkun, Collins, and Jeanjean (2016) and Kronbauer, Marquezan, Barbosa, and Diehl (2011) point out that prior research on the association between IFRS and earnings smoothing provide mixed evidence on whether IFRS increases or decreases the earnings smoothing. In GCC markets, as IFRS environments, Alareeni (2018) asserts that smoothness is practiced in GCC but for the managers' benefit rather than stakeholders' benefit. On the other hand, Hamdan (2017) finds that increased accounting conservatism in GCC has positive effect on reducing information asymmetry and increasing financial reporting credibility. Shubita (2015) examined the association between income smoothing as a case of earnings smoothness and quality of earnings and concluded that smoothness improves earnings quality in the GCC. Therefore, the hypothesis is:

H4: There is no association between accounting conservatism and earnings smoothness.

3.3 AUDITING CONSERVATISM AND EARNINGS QUALITY

An audit serves as a mechanism in mitigating conflicts between preparers being the agents of the firms, and stockholders being the principals of the firms, by attesting their opinions on financial statement credibility. Audit opinions should be objective, unbiased, independent, clear, reliable and dependable. Auditors need to exercise audit conservatism in the audit approaches and in expressing their opinions. Suhardianto and Leung (2020) assert that the auditor uses auditing conservatism (AuC) to maintain the audit risk at an

acceptable level. AuC is the extent to which the auditors comply with the audit guidelines in the course of an audit to ensure financial statements are fairly presented. Sun, Cahan, and Xu (2016) supported this situation as they concluded that the auditors in China have increased AuC to comply with sanctions imposed by the China Securities Regulatory Commission. In the case of a high level of managerial opportunistic behavior and information asymmetry between preparers and stockholders, auditors need to be more conservative in their audit approach and reporting. This means that auditors should expand the sample size, extend the audit inquiries and observations, and be ready to issue modified reports if the situation is warranted. Users of audit reports have placed their trust on auditors in providing assurance services and auditors are seen as an independent third party.

In Oman, the auditors need to express whether a report is an unqualified or clean audit report, or a modified audit report. An unqualified report means the auditors have conducted various audit approaches and are satisfied that the financial statements are fairly presented. A modified audit report means the auditors have some reservations on the quality of the financial statements due to non-compliance with measuring or reporting items in the statements. On top of that, auditors are expected to express whether it is a positive or a negative modified report. If it is a positive modified report, the auditor feels there is a material departure from GAAP or unable to form an opinion that warrant an adverse or qualified opinion. For a negative modified report, this means the degree of objectivity in measuring and reporting the financial items is low. Apart from those unqualified or clean audit reports, Omani auditors are expected to disclose the rationales for expressing the modified reports and implications of those non-compliance on the financial statements as a whole. Failure to discharge these responsibilities might expose auditors to litigation, liabilities and lost reputation. To avoid this, auditors need to exercise a higher level of audit conservatism to even out the lack of accounting conservatism to ensure quality of earnings. Both Fafatas (2010), and Kausar and Lennox (2017) conclude that auditors use AuC in compensating for a lack of accounting conservatism, in particular, in the case where auditors issue a going concern opinion if the book values of a firm's assets are higher than its expected liquidation values. Elfouzi and Zarai (2009) find that auditors in Tunisia issue a modified audit for those firms that have relatively poor AC and EQ. Auditors use modified audit reports as a mechanism to alert stockholders on the earnings quality. Salehi,

Tarighi, and Sahebkar (2018) assert that auditors in Iran use AuC to reflect the economic facts about financially distressed firms. In short, AuC and EQ exist in a positive manner but we need to understand the extent of this relationship as it appears in Oman. Again, as this study uses four EQ proxies, the hypotheses were developed as below.

3.3.1 AUDITING CONSERVATISM AND EARNINGS PERSISTENCE

Vichitsarawong and Pornupatham (2015) find that the firms with modified audit report have low earnings persistence. Issuing a modified audit report reflects different degrees of problematic issues in clients' firms. For example, if the adverse audit report (as one of the riskiest modified audit reports) was issued, the degree of earnings persistence is high reflecting that the degree of clients' problems is high. Gallizo and Saladrignes (2016) pointed out that the probability of receiving a modified audit report is high if the firm has frequent losses. Occurrence of losses reflects low client ability to continue as a going concern which means that the company might be under liquidation in the foreseeable future. Here, the auditor uses a modified audit report or auditing conservatism to protect the investors and guide them to take a right decision about their investment. Therefore, the hypothesis is:

H5: There is positive association between auditing conservatism and earnings persistence.

3.3.2 AUDITING CONSERVATISM AND ACCRUAL QUALITY

Prior studies (Kausar and Lennox, 2017; Chen et al., 2014; Menon and Williams, 2010) document significant negative market reactions to the issuance of modified audit report especially going concern report, indicating that such opinions convey bad news to investors. Many reasons are behind issuance of this type of audit report such as technical violation of a debt covenant, problem with obtaining financing (Menon and Williams, 2010) and having large accruals (Kausar and Lennox, 2017). If the firms have more accruals, the auditors are more likely to issue a modified audit report which means that the auditing conservatism is positively associated with greater accruals. Francis and Krishnan (1999) pointed out that more accounting accruals means more uncertainty and estimation error because of potential estimation error and a greater chance that high-

accrual firms have undetected asset realization and/or going concern problems. These firms are under a case of risk exposure and the auditors can compensate for this risk by issuing a modified audit report. Therefore, the hypothesis is:

H6: There is positive association between auditing conservatism and accruals quality.

3.3.3 AUDITING CONSERVATISM AND VALUE RELEVANCE

Turning to the association between auditing conservatism and value relevance, the literature reviews have discussed this association and find that it is positive and significant; for example, Ittonen (2012) pointed out that the modified audit report includes valuable information about estimation and risk of future cash flow which is very important investor information. Robu and Robu (2015) assert that the modified audit report gives positive signal about the going concern of the firm in the foreseeable future. In this regard, a modified audit report enhances investor confidence considering that auditors have reasonable evaluation of firms' internal information. The modified audit report is important because it provides new information to the investors. Investors might change their decisions upon receiving new information. Hapsoro and Suryanto (2017) give some examples of changing investor decision when the firms receive modified audit report indicating that this type of audit report has good news for those investors. Therefore, the hypothesis is:

H7: There is positive association between auditing conservatism and value relevance of earnings.

3.3.4 AUDITING CONSERVATISM AND EARNINGS SMOOTHNESS

Goel and Thakor (2003) pointed out that earnings smoothing is one case of earnings management which is used to make earnings look less variable over time. Basically, there is a positive association between earnings smoothing and earnings management. Mendes, Rodrigues, and Esteban (2012) assert that the management uses income smoothing practices to increase income in some bad years and decrease it in good years, in order to minimize the long-term fluctuations. Reguera-Alvarado, de Fuentes, and Laffarga (2018) find that external auditing is an important mechanism to minimize earnings management by improving the quality of accounting

information. More specifically, they find that auditors use conservatism (auditor conservatism) to minimize the earnings management. Lopes (2018) finds that with high quality audit, the earnings management reduces because the earnings management is one type of manipulation of results and therefore the auditor should report this case in the audit report. Kanagaretnam, Yeow, and Lobo (2010) find that the auditor constrains earnings management when the firm is using income increasing earnings management practices as this will affect the reputation of the auditor and the auditor has an important role in mitigating the risk resulting from earnings management practices. Therefore, the hypothesis is:

H8: There is positive association between auditing conservatism and earnings smoothness.

4. RESEARCH METHODOLOGY

4.1 SAMPLE AND DATA

The study examines the financial statements of all the 109 listed firms on the Muscat Securities Market (MSM) in Oman for the 6-year period from 2012 to 2017. Altogether we have 35 firms from the financial sector, 40 from the industrial sector and 34 from the services sector. The study eliminated 2 from the financial sector and 1 from the industrial sector because they were listed on the MSM only from 2017. With this, we have 106 firms' reports generating a total of 636 firm-year observations. The study extracts the firms' details from the MSM Companies' Guides (2017 and 2018), and the financial reports at Mendeley Data (2020).

The study uses three key variables. These are accounting conservatism (AC), auditing conservatism (AuC), and earnings quality (EQ). For AC, accruals are used to measure the extent of conservatism because preparers could use accrual to smooth the earnings. In line with both Givoly and Hayn (2000) and Givoly, Hayn, and Natarajan (2007) we define accrual as income before extraordinary items and discontinued operations plus depreciation expenses minus operating cash flows (operational accruals). The total of which is divided by total asset at beginning of the accounting period. For AuC, we use modified audit reports to be in line with prior studies including Basu, Hwang, and Jan (2005), Sen (2005), and Kausar and Lennox (2017).

For EQ, we use earnings per share (Kamarudin and Ismail, 2014) as a measurement of earnings persistence. Though each of the variables has its limitations including reliability and accuracy in measuring and reporting assets and liabilities and incomes, we could not access fair values of these items in the financial statements. With this, we use size of the firms measured by an algorithm of the total assets, type of audit firm that is Big 4 and non-Big 4, and risk which is measured by debt to equity ratio to assess the interplay between the three variables. Table 1 maps the variables, definitions and measurements that we have included in the evaluation process.

TABLE 1
Definition and Measurement of Variables

Variable	Code	Measure	Method of measurement
Independent variable			
Accounting conservatism	AC	Total Accruals	Income before extraordinary item and discontinued operations plus depreciation expenses minus operating cash flows (operational accruals) and divided by total asset at beginning of period. (Givoly et al., 2007)
Auditing conservatism	AuC	Issuing modified audit report	Binary variable, 1 if modified audit report otherwise 0 (Lennox and Kausar, 2017)
Dependent Variable: Earnings Quality			
Persistence	PER	β measures persistence	$Earning_{t+1} = a + \beta Earning_t + et$ (Dechow et al., 2010)
Accrual Quality	AQ	Accrual items	(Net income before extraordinary items- cash flow from operation)/ Total Assets (Richardson, 2003).
Value Relevance	VR	explanatory power of regression (R^2)	R - square of Earning or book value of shares whichever high (An, 2017)

TABLE 1 (continued)

Variable	Code	Measure	Method of measurement
Smoothness	SM	Standard Deviation (SD) of earnings and cash flow	SD(Net income before extraordinary items)/Total Assets)/SD(Cash flow from operation/Total Assets) (Dechow et al., 2010)
Control variables			
Size	S	Total assets	algorithm of Total assets
Risk	R	debt to equity ratio	Debts/ equity
Audit firm size	BIG4	Binary variable	1 if big 4 otherwise 0
Industry Type	ACTV	Binary variable	1 if non-financial firm otherwise 0

4.2 MODEL SPECIFICATION

With this, we construct the following models for assessing the interplay between accounting conservatism (AC), auditing conservatism (AuC) and quality of earnings (EQ).

- (1) $EQ(PER)_{it} = \alpha_{it} + \beta_1 AC_{it} + \beta_2 AuC_{it} + \beta_3 S_{it} + \beta_4 R_{it} + \beta_5 BIG4_{it} + \beta_6 ACTV_{it} + \epsilon_{it}$
- (2) $EQ(AQ)_{it} = \alpha_{it} + \beta_1 AC_{it} + \beta_2 AuC_{it} + \beta_3 S_{it} + \beta_4 R_{it} + \beta_5 BIG4_{it} + \beta_6 ACTV_{it} + \epsilon_{it}$
- (3) $EQ(VR)_{it} = \alpha_{it} + \beta_1 AC_{it} + \beta_2 AuC_{it} + \beta_3 S_{it} + \beta_4 R_{it} + \beta_5 BIG4_{it} + \beta_6 ACTV_{it} + \epsilon_{it}$
- (4) $EQ(SM)_{it} = \alpha_{it} + \beta_1 AC_{it} + \beta_2 AuC_{it} + \beta_3 S_{it} + \beta_4 R_{it} + \beta_5 BIG4_{it} + \beta_6 ACTV_{it} + \epsilon_{it}$

We have also taken the following into considerations to account for any unaccountable variables and constraints.

α_{it} = Constant

β = Beta Coefficient

ϵ_{it} = Error term

i^{th} = Firm

t^{th} = Period

The study uses a multiple regression econometric model to assess the interplay between AC and AuC on EQ on all the 636 firm-

year observations. The multiple regression econometric model helps identify changes or variations in the values of any variables, whether it is a dependent variable (earnings quality) or independent variables (accounting conservatism and auditing conservatism) due to control variables (size, risk, size of auditor and industry type). The dependent variable is a linear function of the independent variables, and these will reveal the extent of interplay between the three variables.

5. EMPIRICAL RESULTS

5.1 DESCRIPTIVE STATISTICS

Table 2 provides a summary of the descriptive statistics of the firms examined. With a mean of AC (0.018), this shows a low level of accounting conservatism among the Omani firms. This means a relatively small proportion of listed firms using AC though the mean level of risk (R) is at 32%. The high R value indicates some firms, in particular banks and financial institutions may face financial threats but not at the going concern level. Big 4 audits the financial statements of most of these firms. We look at the audit reports; 74.5% of the reports are modified due to auditees deemed not to be a going concern. For the earnings quality, measured by persistence or PER, accrual quality AQ, reflect a negative sign -0.09 and -0.82 respectively and value relevance VR (Book value of share), smoothness SM reflect a positive sign of 0.11 and 0.51, respectively meaning though the EQ level remains marginally positive (except for PER and AQ) during the period of study, Omani listed firms could sustain their earnings trend and survive in the short term.

It would be interesting to assess the survival and growth rate among firms. Persistence, measured as the slope-coefficient (β_1) is equal to -0.09. This result is highly close to zero which implies that earnings of Omani firms are much less persistent and extremely transitory. As a result, earnings quality as decision usefulness is relatively poor; and thus does not provide valuable financial information to stakeholders. The absolute value of accrual quality (AQ) is 0.82 which is relatively high and indicates lower earnings quality of Omani firms. The R^2 of value relevance in terms of book value is low (10.8%) indicating less earnings quality as the value-relevance of Omani firms is not high, thus earnings quality as decision usefulness is low. In terms of smoothness, the mean (0.51) is relatively high which indicates low earnings quality of Omani

5.2 CORRELATION AND MULTICOLLINEARITY

This study uses the Pearson's correlation matrix to assess the degree of associations among the independent variables (AC and AuC) and the control variables. A low or moderate association suggests a lack of multicollinearity between the independent variables and the control variables. Table 3 shows that the relationship between the AuC and SM is positive and statistically significant at the 5% as the coefficient is 0.201, but there is no effect of AC on EQ. With this, we support the first hypothesis that in Oman, AuC has a positive and significant impact on EQ in terms of smoothness but AC doesn't have effect on the EQ. This suggests the need of government agencies and professional bodies to emphasize that preparers exercise conservatism in the course of measuring and reporting financial details, while auditors need to remain vigilant in discharging their due diligence and duties of care. For the type of audit firms, Big4 is negatively related to EQ (VR) at the 5% significance level and with a coefficient = -0.231 with a p -value of 0.017. This shows Big 4 tends to focus more on audit conservatism than those non-Big 4 and local firms. This could due to the Big 4 firms' reputations and availability of resources in comparison to their local counterparts. Type of industry (ACTV) has positive relationship with AC at the 0.05 level of significance which means that in non-financial sector, the management prefers to use accounting conservatism firms. Also, ACTV has positive relationship with EQ (PER) and (SM) at the 0.05 significance level and with a coefficient = 0.208 and 0.193 respectively which means that the current earnings in the non-financial firms will persist into the future and continue from period to period. Finally, firm size has negative relationship with EQ (SM) and (PER) with a coefficient of -0.303 and -0.227 respectively. This result shows that the larger firms tend to keep EQ in a high level to avoid any earnings volatility. For the remaining independent, control and dependent variables, they are insignificant at either 1% or 5% level of significance thus signifying no relationship exists among the variables. Table 3 summarizes the results of the correlations and multicollinearity between AC, AuC and EQ in all four proxies.

TABLE 3
Correlation Matrix

Variables	AuC	AC	S	R	Big4	ACTV	PER	AQ	SM	VR
AuC	1									
AC	-0.195*	1								
S	0.034	-0.161	1							
R	0.178	-0.173	0.304**	1						
Big4	-0.132	0.181	0.155	0.110	1					
ACTV	-0.007	0.201*	-0.542**	-0.221*	-0.232*	1				
PER	-0.09	0.082	-0.227**	-0.088	-0.080	0.208*	1			
AQ	-0.019	-0.155	0.046	-0.012	0.146	-0.158	-0.033	1		
SM	0.201*	0.021	-0.303**	-0.062	0.071	0.193*	0.046	0.13	1	
VR	-0.170	0.030	-0.062	-0.098	-0.231*	0.189*	0.028	0.02	-0.01	1

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

5.3 REGRESSION ANALYSIS RESULTS

5.3.1 MODEL 1: EQ -PERSISTENCE

Table 4 shows the results of the association between AC, AuC and EQ in terms of persistence. Persistence is measured as the slope-coefficient of earnings as used by Dechow et al. (2010).

Table 4 shows that the model is insignificant as the F -value 0.533 with significant 0.782 (p -value > 0.05) and the R -square is only 3.1% indicating that only 3.1% of the dependent variable is predictable by the independent variables. The results of table 4 indicate that neither AC nor AuC have any effect on EQ in terms of persistence which means that the accounting conservatism and auditing conservatism did not support the persistence of earnings quality. Therefore, H1 is accepted as there is no effect of AC on EQ which indicate that EQ will not sustain by using conservative accounting practices. On the other hand, H5 is rejected as there is no relationship between AuC and EQ in terms of persistence. The users of financial statements cannot depend on AuC to make their decisions about the sustainability of EQ and AuC will not improve the expectations of those users toward EQ.

TABLE 4
Regression Results of Model 1 (EQ = Persistence)

	Model	B	T	Sig.
	(Constant)	1.283	0.453	0.652
	AuC	-0.815	-1.012	0.314
	AC	-9.202	-0.955	0.342
	S	0.032	0.065	0.948
	R	0.345	0.276	0.783
1	Big4	-0.700	-0.833	0.407
	ACTV	-0.466	-0.516	0.607
	R-Square			3.1%
	Adjusted R ²			-2.7%
	F-value			0.533
	Sig.			0.782

5.3.2 MODEL 2: EQ -ACCRUAL QUALITY

Table 5 shows the results of the association between AC, AuC and EQ in terms of accrual quality. The study measures accrual quality using similar method used by Richardson (2003).

Table 5 shows that the model is insignificant as *F*-value is 1.269 with significance 0.279 (*p*-value > 0.05). The *R*-square is only 7.1% indicating only 7.1% of the dependent variable is predictable by the independent variables. This result shows that AC and AuC are not good indicators for EQ in terms of accrual quality. As shown in table 5, H2 is accepted that there is no association between AC and EQ which means that AC did not raise the EQ and it did not support the conversion of accrual into cash to help the investors in their decision making. H6 is rejected as AuC did not support the idea of sending bad news to investors about earnings quality. Therefore, the investor cannot depend on issuing a modified audit report to ensure the earnings quality. The results indicate neither AC nor AuC provides useful information in measuring the quality of accruals.

TABLE 5
Regression Results of Model 2 (EQ = Accrual Quality)

Model	B	T	Sig.
(Constant)	0.505	0.204	0.839
AuC	-0.136	-0.194	0.847
AC	-14.810	-1.757	0.082
S	-0.206	-0.482	0.631
R	-0.732	-0.669	0.505
2 Big4	1.156	1.575	0.118
ACTV	-0.864	-1.093	0.277
<i>R</i> -Square			7.1%
Adjusted <i>R</i> ²			1.5%
<i>F</i> -value			1.269
Sig.			0.278

5.3.3 MODEL 3: EQ - VALUE RELEVANCE

The study measures value relevance using similar method used by Ali and Hwang (2000) and An (2017) as value-relevance is the explanatory power of earnings and book value of equity for stock returns. The study tested explanatory power of earnings and book value through regression of R^2 as it found that R^2 of earnings is equal to .010 whereas the R^2 of book value is equal to 22.4% which means that the explanatory power of book value explains 22.4% of variation of EQ. Therefore, the study will use book value of equity to test the effect of AC and AuC on EQ (VR). Table 6 shows the results of the association between AC, AuC and EQ in terms of value relevance.

Table 6 shows that the model is insignificant as *F*-value is 1.793 with level of significance 0.108 (*p*-value > 0.05) and the *R*-square is only 9.8% indicating that only 9.8% of the dependent variable is predictable by the independent variables. This result shows that AC and AuC are not in a good position to evaluate the EQ in terms of value relevance. The results of table 6 indicated that H3 is accepted as there is no association between AC and EQ which means that the conservative accounting practices did not improve the value relevance in terms of book value of equity. On the other hand, H7 is rejected as there is no association between AuC and EQ which

means that AuC did not give an indicator for the investors to predict the value relevance of earnings.

TABLE 6
Regression Results of Model 3 (EQ = Value Relevance)

	Model	B	T	Sig.
	(Constant)	0.376	0.993	0.323
	AuC	0-.209	-1.947	0.054
	AC	0.326	0.253	0.801
	S	0.014	0.208	0.836
	R	-0.044	-0.265	0.792
3	Big4	0.097	1.762	0.081
	ACTV	0.054	0.447	0.656
	R-Square			9.8%
	Adjusted R ²			4.3%
	F-value			1.793
	Sig.			0.108

5.3.4 MODEL 4: EQ – SMOOTHNESS

Table 7 shows the results of the association between AC, AuC and EQ in terms of smoothness. The study proceeds to regress the results and find that the model is significant at the 0.01 ($p < 0.01$) level of significance.

The, F -statistic (3.240), R^2 equals to 16.4% and adjusted R^2 equals to 11.3% indicating that only 16.4% of the dependent variable is predictable from the independent variables. This result indicates that a measure of the observed outcomes is replicated by the model, based on the proportion of total variation of outcomes. Even with the adjusted R^2 of 11.3% by taking into account the phenomenon of explanatory variables including firms' size, Big 4 versus non Big 4 and sectors, the results show no biasness in the estimations of the population value. Table 7 shows that there is a positive and significant effect of AuC on EQ while no significant AC effect was found on EQ at the 0.01 level of significance. In sum, users rely more on AuC when determining EQ. With this, it supports H8 but not H4. This posits that the level of audit conservatism is greater than accounting conservatism when users assess the EQ.

Table 7 shows that AC does not have effect on EQ which means that H4 is accepted while AuC has effect on EQ in terms of smoothness as the *t*-value 2.433 is significant at 0.05 which indicates that H8 is accepted. This result indicates that when the auditor not the management uses AuC but not AC to ensure that there are no irregular variations in the earnings then the decision usefulness will improve.

TABLE 7
Regression Results of Model 4 (EQ=Smoothness)

Model	B	T	Sig.
(Constant)	0.725	3.906	0.000
AuC	0.128	2.433	0.017
AC	-0.204	-0.323	0.748
S	0-.084	-2.625	0.010
R	-0.018	-0.214	0.831
4 Big4	-0.273	-2.439	0.017
ACTV	0.040	0.683	0.496
R-Square			16.40%
Adjusted R ²			11.30%
F-value			3.240
Sig.			0.006

5.4 TESTING OF CONTROL VARIABLES

For the control variables, we use size of the company, risk, industry type and size of audit firm (Big 4 vs. non-Big 4 audit firm). The coefficient for Audit firm size is negative and statistically significant at the 0.05 significance level, indicating EQ are negatively related to audit firms' size whether it is a Big 4 or a non-Big 4 audit firm. Clients of Big 4 auditors have expected a lower level of EQ which means users expect a higher earnings trend if the financial reports were audited by a non-Big 4 audit firm. This could be due to 65% of the Big 4 audit firm issued modified audit reports during the period of study indicating that EQ of their clients is questionable. The result is not in alignment with those findings by Slaheddine (2015) who concluded a positive relationship existed between audits by a Big 4

audit firm and the firms' EQ. This could also be due to Big 4 firms tending to follow strictly on the AuC in line with their international practice and reputations. Consistent with the findings of Gajevszky (2014) and Gerayli, Yanesari, and Ma'atoofi (2011), firms audited by Big 4 auditors find that Big 4 auditors tend to audit firms with a higher EQ than those non- Big 4 auditors.

For the remaining three control variables (firm size, industry type and risk), we find there is no relationship between these three variables and EQ, though both Nelson and George (2013), and Shehu (2012) detected a positive association between risk and EQ. The positive relationship between risk and EQ could be due to the signaling theory, whereby a high level of risk may improve the level of EQ and eventually giving the firms opportunities to attract more investments (Hassan and Farouk, 2014). In this study, risk does not have any significant relation to EQ due to the moderate level of risk among the Omani financial sector and the business environment. The local geopolitical scenario and landscape reflect the market stability and investor confidence in the level of reported EQ.

For the firm size, we use firm total assets for measurement. Though prior literature yields mixed findings, we find no significant relationship between a firm's size and EQ in all its proxies except for smoothness of earnings as there is a negative effect between size and smoothness; t-value is -2.625 which is significant at the 0.05 level. This shows that the larger the firm, the lower the likelihood of income smoothing. Large companies have little need for earnings smoothing. This aligns with the Pradipta and Susanto (2019) findings. This means users focus on EQ for all sizes of the firms for their decision making process. For the firms' industry, our finding is consistent with Bamiatzi, Bozos, and Cavusgil (2016) who conclude that firms' industry has a weak effect on the individual firm's EQ. Finally, we find no significant relationship between industry type and EQ. This is not in alignment with Pagalung and Sudibdyo (2012) who find a negative relationship between these two variables and Gu, Lee, and Rosett (2002) who conclude significant industry differences as non-financial industries have a higher variability.

5.5 DISCUSSION OF THE RESULTS

Preparers of financial statements are expected to use accounting conservatism (AC) and auditors are required to ensure fairness in the

financial statements to enhance earnings quality (EQ). However, in cases where AC is absent, auditors step in by imposing a higher level of auditing conservatism (AuC) to counter balance the fairness in the estimations and reporting of EQ. Using all the financial reports of listed firms in Oman for the 6-year period from 2012 to 2017, this study finds a positive and significant effect of auditing conservatism on earnings quality in terms of earnings smoothness but no relationship between accounting conservatism and earnings quality. This means the Omani auditors play a major role in ensuring the fairness of the financial status, and in alerting stockholders on the lack of accounting conservatism and minimize the earnings management resulted from earnings smoothness. Omani auditors issue modified audit reports to ensure both preparers and users are aware of the importance of high earnings quality and earnings smoothness. Our results are consistent with Kausar and Lennox (2017) who find that those auditors who issued modified reports in particular going concern audit reports, help to compensate for a lack of accounting conservatism. Also, this result is in line with Lopes (2018) and Reguera-Alvarado et al. (2018) who find that auditors play an important role in minimizing earnings management resulted from income smoothing. This could be because “auditors have incentives to determine earnings more conservatively than managers do, because of their greater legal liability exposure” (Basu et al., 2005, 217).

With regard to the association between AuC and earnings persistence, our findings deviate from both Vichitsarawong and Pornupatham (2015) and Gallizo and Saladrigues (2016) who conclude that a firm’s earnings are impacted negatively upon receiving a modified audit report. Also, the result of association between AuC and value relevance is not in line with Robu and Robu (2015) and Ittonen (2012) who find that a modified audit report gives good information to investors about firm survival and growth. With regard to the association between AuC and accrual quality, the result is not in line with Menon and Williams (2010) and Chen et al. (2014) who find that for firms having a large amount of accrual, the auditors tend to issue a modified audit report on their going concern problem. The finding is not in line with Asri (2019) and Shubita (2015) who find a positive association between accounting conservatism and earnings quality. They stipulate that accounting conservatism will help improve earnings quality because it serves as alert warnings and

signals to both the preparers and users. However, both Gajevszky (2014), and Salehi et al. (2018) conclude that there is a negative relationship between accounting conservatism and earnings quality due to preparers being motivated by earnings management for their own personal gains and returns. On the other hand, the result of AC is in line with some prior studies with respect to earnings persistence (e.g., Zeghal and Lahmar, 2016; Andre et al., 2015; Preiato et al., 2015) who find that using of AC in the environment of IFRS is reduced because it has effect of neutrality of financial statements and therefore it is expected that AC does not have impact on earnings persistence. With respect to association with value relevance, the result conflicts with Hejranijamil et al. (2020) and Brown et al. (2006) who find negative association between them. Also, the result is consistent with Dimitropoulos (2008) who find that earnings accruals are not influenced by conservatism because they are generated according to the realization basis and not cash flow basis. Turning to the association between AC and smoothness, the result of this study is inconsistent with prior studies (e.g., Cerqueira and Pereira, 2020; Rostami et al., 2019; Hsu et al., 2017; Pashaki and Kheradyar, 2015; Lara et al., 2014) who find that AC improves the quality of accounting information by reducing manager optimistic behavior. Put together, both AC and AuC serve an important role in ensuring EQ and earnings persistency. Both preparers and auditors need to put their efforts in ensuring the financial statements reflect fair presentation on the status as at the balance sheet dates. Failure to assert the needed efforts could mean a heavier reliance on another party to balance the quality of financial statements and earnings.

Finally, the results indicate that conservatism, whether it is accounting or auditing, is important to improve the EQ. More specifically, the Omani stockholders rely heavily on auditing conservatism which means stockholders are prepared to receive modified audit reports. Preparers should play their roles in ensuring a proper and reliable design and implementations of internal control systems. However, Omani regulatory bodies have adopted IFRS where there is no emphasis on accounting conservatism in its conceptual frameworks. This means stockholders may have to rely more on auditing conservatism. For the auditors, due to the high regulated business environment within and outside Oman, Omani auditors tend to issue modified audit reports to save themselves from litigation risk and to safeguard their reputations and branding.

6. CONCLUSION

This study examines the effects of auditing conservatism (AuC) measured by modified audit report, accounting conservatism (AC) measured by total accruals on earnings quality (EQ) measured by four common proxies; persistence, accrual quality, value-relevance and smoothness among all the 106 Omani listed firms for the period from 2012-2017. We use firm size, risk and audit firms as control variables to assess the interplay between AuC, AC and EQ. We find a positive and significant effect of AuC on EQ (SM) but no significant impact of AC on EQ. This means users tend to rely on audit reports for EQ, and the audit reports for flagging any lack of AC in the course of estimating and reporting the financial results. The study provides additional evidence from analyzing all companies in the sample where it pointed out that the presence of auditing conservatism and absence of accounting conservatism is preferable for the larger sized firms which are audited by big 4 audit firms. Modified audit reports become the tool for alerting users on any deficiency in EQ, and for reflecting on individual firm's lack of proper internal control systems and on poor earnings persistency strategy.

The study uses Omani environment as our laboratory due to its prowess in the economy, continuing efforts in its accounting and auditing reporting systems, and its relative insulation from geopolitical exposure. Also, this is the first study of this nature in Oman. This could help international investors to understand and appreciate the seriousness of the Sultanate in taking appropriate steps to emphasize accounting conservatism and audit conservatism that would eventually lead to earnings quality and confidence in the reported results. The findings have implications to audit and accounting regulators preparers, auditors and users for the need to re-emphasize conservatism. Immediate and positive actions should be taken from what we have learned from the literature and this finding.

This study suffers from some limitations which are common in research using publicly available data to make conclusions about earnings quality. The study uses the client financial reports including auditor reports to measure to the main variable of the study. Further, this study focuses on one measure of auditor conservatism which is issuing the modified audit report, one measure of accounting conservatism which is total accrual and only four measures of

earnings quality. Other measures of auditor conservatism, accounting conservatism and earnings quality may yield different results and provide additional insights into earnings quality. Another limitation is that little is known about the nature of audit failure cases which are filed against the auditor; therefore we use dummy variable to measure this variable.

Though this is the first known study of its type in Oman, we suggest similar studies should be conducted in other emerging economies. Future research could include focus group forum, semi structured interviews with key players in estimating and reporting of financial information including regulators, auditors, and financial statement users (Chong, 2006). The process will help us to learn from one another and to expand our vision and understanding on key purposes of reporting EQ. All these inputs could project a positive image of the accounting and auditing professions, and provide better measuring and reporting service to the stakeholders.

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