

Client Importance and Earnings Management: The Moderating Role of Audit Committees

Vineeta D. Sharma; Divesh S. Sharma; Umapathy Ananthanarayanan

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SUMMARY

This study provides empirical evidence on how the association between the economic importance of a client to the auditor and earnings management is moderated by the audit committee. We employ city office-level client importance fee-based measures, both performance-adjusted discretionary total and current accruals as proxies for earnings management, and a measure of audit committee best practices. We document a positive association between client importance and our two proxies for earnings management. This association is stronger for income-increasing earnings management. However, the association between client importance and earnings management is more pronounced when the audit committee does not meet best practices. We infer that the economic importance of a client appears to threaten auditor independence and thus the quality of financial reporting, but only when the audit committee exhibits characteristics associated with the provision of weak oversight. We also find that the association between client importance and earnings management is conditional on inside ownership, growth, leverage, and firm size, which are moderated by the audit committee. This study is the first to demonstrate that audit committees can moderate threats to auditor independence thus protecting the quality of financial reporting. The study discusses potential implications for policy making and empirical research.

Keywords: [audit committee](#), [auditor independence](#), [accruals](#), [corporate governance](#), [fees](#), [earnings management](#), [nonaudit](#)

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