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# ANTI-CORRUPTION DISCLOSURE QUALITY AND EARNINGS MANAGEMENT IN THE UNITED KINGDOM: THE ROLE OF AUDIT QUALITY

## ABSTRACT

**Purpose:** Building upon institutional pressures on firms to deal with corruption, this study aims to investigate the association between a firm's engagement with anti-corruption disclosure quality (ACD\_Q) and earnings management (EM). Also, we examine the moderating role of audit quality (AQ) in the association between ACD\_Q and EM.

**Design/methodology/approach:** We constructed an ACD\_Q index based on the 2010 UK Bribery Act and taking into account a wide range of rules on corruption and bribery, including; OECD, World Bank, UNCTAD, UNGC, UNCAC, and GRI. Generalized Method of Moments (GMM) and panel regression were employed to examine the association between ACD\_Q and EM.

**Findings:** Using a sample of 2695 firm-year observations of the UK's FTSE-350 from 2008 to 2018, we find that ACD\_Q is negatively associated with EM. In addition, this negative relationship is contingent on audit committee independence and audit committee expertise. This finding is supported by additional robustness and sensitivity analysis.

**Practical implications:** Our empirical evidence reiterates the crucial need for more concerted efforts to ensure corporate engagement in anti-corruption practices with a view to reducing earnings manipulations.

**Originality/value:** This study contributes to the limited evidence that investigates how ACD Q influences EM in the UK after the introduction of the UK Bribery Act in 2010. Furthermore, by considering the period from 2008 to 2019, we investigate the potential moderating role of UK CG reforms in EM reduction. In particular, we assess for the first time the moderating effect of audit committee mechanisms on the ACD Q and EM nexus.

## KEYWORDS

Anit-corruption disclosure, earnings management, audit quality, FTSE 350-UK.

## 1. INTRODUCTION

Due to information asymmetry between managers and owners, the nature of accounting accruals provides managers with a significant level of freedom in determining reported earnings. Managers can influence the quality of disclosed information by manipulating earnings to maximize their interests (Healy, 1985; Chung et al., 2002; Holthausen et al., 1995). The flexibility of Generally Accepted Accounting Principles enables managers to exercise some judgment in estimating reported earnings that may not fully reflect the underlying economic conditions of firms (Prior et al., 2008). This opportunistic use of managerial discretion is generally referred to as “earnings management” (EM) (Healey & Wahlen, 1999; Leuz et al., 2003).

Corruption has received massive attention over the past two decades due to scandalous corporate collapses (Blanc et al., 2019; UNGC, 2015) and associated societal problems and ethical dilemmas (Cardoni et al., 2020; Hauser and Hogenacker, 2014; Sanyal and Samantha, 2004; UNGC 2015). Transparency International (TI) defines corruption as “the misuse of authority for personal benefit” (Blanc et al., 2019; Errath et al., 2005: 7). It adds that corruption encompasses bribery (soliciting, offering, or accepting a bribe) involving public officials or private sector individuals and includes conflicts of interest, fraud, and money laundering (ISO 2010). Nevertheless, corporate corruption is not easy to identify. Hess (2009), for example, discusses the need for regulators to set up guidelines for companies to report their anti-corruption practices. Corruption activities are not always motivated by malice; they may sometimes arise due to disguised good deeds. Karim et al. (2016) argue that corruption is the misappropriation of the trust of individuals and organizational resources for personal or private gain by engaging in irresponsible behaviours. In

addition, Osuji (2011) stated that corporate engagement in corruption might result in a loss of investor faith, a decline in market share, and a rise in poverty and social inequality.

To avoid these negative consequences, businesses provide information about their corporate social responsibility (CSR), which often includes anti-corruption information, to assure stakeholders that their annual results are responsibly and legally achieved.

Anti-corruption disclosure quality (ACD\_Q) not only discourages corruption but also fosters openness and accountability by raising public awareness about anti-corruption measures (KPK, 2020). Arguably, ACD\_Q has been largely influenced by a business contemplating its social responsibilities that would include an accountability pledge in its reporting, increased transparency, fight against corruption and decreasing EM (Bozzolan et al., 2015; Hess, 2009; Kuo et al., 2021; Schwartz & Carroll, 2003). As part of ESG disclosure, recent literature highlighted the positive association of ACD\_Q with firms' performance and reputation (Álvarez Etcheberria and Aldaz Odriozola, 2018; Carrillo et al., 2019; Branco et al., 2019). Despite rising public demand for enhanced openness in anti-corruption initiatives (Halter et al. 2009), ACD\_Q has received far less scholarly efforts than other CSR dimensions (Wilkinson 2006). The lack of attention is explained not only by a lack of awareness of the critical role of ACD\_Q but also by the covert, concealed character of corruption, which makes the problem uncomfortable for businesses (Wilkinson 2006).

Although a large number of prior studies have examined the relationship of ESG disclosure with EM (e.g., Gerged et al., 2021; Patten and Trompeter, 2003; Velte, 2019; Choi et al., 2013; Gras-Gil et al., 2016; Kim et al., 2012; Liu, Shi, Wilson, & Wu,

2017; Muttakin et al., 2015; ), to the best of our knowledge, no study has explicitly examined how ACD\_Q affects EM. Our study contributes to the literature by providing evidence on the ACD\_Q-EM nexus in the UK, with a history of significant governance and regulatory shifts. Thus, we pose the first question: Is anti-corruption disclosure quality linked with earnings management?

An effective audit process, including a functional audit committee, is one of four pillars of corporate governance proposed by the Institute of Internal Auditors (IIA 2005). Prawitt et al. (2009) and Rogers and Stocken (2005) argue that a high-quality audit is critical in assuring financial reporting because management's estimates are more biased when firms' accounts are not evaluated by a third party. Likewise, Brown and Pinello (2007) stated that a high-quality audit could be a credible detection method to reduce earnings management incidence. Drawing on prior studies (e.g., Brown and Pinello, 2007; Prawitt et al., 2009; Rogers and Stocken, 2005; Saeed and Saeed, 2018), our study focuses on the monitoring function of audit quality in reducing managers' involvement in EM practices. As a result, the second question is: Does firms' adherence to high-quality audits mitigate EM practices?

Previous studies limitedly focus on the corporate disclosure-EM nexus (e.g., Gerged et al., 2021; Choi et al., 2013; Sun et al., 2010; Velte, 2019), with no consideration of the moderating effect of audit quality or audit committee function on this relationship. Therefore, this study contributes to the existing literature by addressing this gap. Therefore, the third question is: Is the association between anti-corruption disclosure quality and earnings manipulation contingent on audit quality?

In brief, our study examines the ACD\_Q -EM nexus in the UK. Also, it explores the expected moderating role of audit quality in this link. Our study differs from previous

studies in several ways. First, to the best of our knowledge, this is the first research paper to investigate the influence of ACD\_Q on EM in the UK. Second, we uniquely examine the role of audit quality in mitigating EM engagement in the UK. Finally, this study, as far as we know, is the first to consider the moderating role of audit quality on the ACD\_Q-EM nexus in the UK.

The study is motivated by the increasing recognition that ethical management practices are essential for attaining profitable and sustainable business outcomes. Given the significance of ethical decision-making in organizations, it is crucial to investigate the contributing factors. This motivated us to investigate the relationship between ACD\_Q and EM for a sample of the FTSE-350 from 2008 to 2018 as our first objective. Moreover, given the increasing emphasis on anti-corruption measures in contemporary business environments, it is crucial to determine whether audit quality moderates the relationship between ACD\_Q and EM. This research is motivated by the need to shed light on how companies can foster a culture of ethical decision-making and reduce instances of unethical management practices. This study has the potential to inform organisational practises that promote ethical behaviour and contribute to the long-term success of businesses by examining the relationships between audit quality, anti-corruption disclosure quality, and earnings manipulation.

The UK Bribery Act requires corporations to evaluate the effectiveness of their current anti-bribery programmes. The act was built on a long history of concern for corruption and also was a response to influential stakeholders' concerns about outdated anti-bribery regulations in the UK. The UK Bribery Act was enacted in April 2010 and came into force in July 2011 (Ministry of Justice, 2011). The UK Bribery Act is defined as "*An Act to make provision about offences relating to bribery; and for connected purposes*" (Islam et al., 2021, p 1854). The UK Serious Fraud Office (SFO)

is the primary agency for implementing the Act, and it has jurisdiction over inspecting and prosecuting firms' offences of bribery and fraud. Sections 1 and 2 of the Act have two general provisions: the "passive" and "active" bribery articles. The former denotes requesting and accepting a benefit to gain or retain business, while the latter refers to the promising, offering, or giving of a benefit to gain or retain business (Milford, 2013). Also, corporations are to be held accountable even if a person linked with the firm commits bribery, which means that agents, contractors, intermediaries, suppliers, and everyone acting on behalf of the firm are subject to the Act (Ministry of Justice, 2011). This makes the UK a particularly appropriate setting to examine the association between ACD\_Q and corporate engagement in unethical conduct, such as earnings management.

Using 2695 firm-year observations of FTSE 350, our findings suggest that UK firms with high ACD\_Q are unlikely to be involved in EM. We also find that independent audit committee members with high-level financial experience can effectively monitor managers' behaviours and reduce their involvement in EM. Most importantly, we find that the negative relationship between ACD\_Q and EM is contingent on audit quality. Overall, our econometric models are robust to endogeneity and alternate measurement concerns.

The rest of the paper is designed as follows: Section 2 discusses the theoretical framework; Section 3 reviews relevant literature on EM and ACD\_Q. Section 4 provides details of the study design. Sections 5 and 6 present the empirical results, robustness test and conclusion.

## **2. THEORETICAL FRAMEWORK**

Three fundamental theories, agency theory, stakeholders' theory, and legitimacy theory, may be employed to underpin the CG, ACD, and EM relationships. According to agency theory, information asymmetry problems associated with the agent-principle relationship might provide opportunities for managers (the agents) to act in their own self-interest rather than the interests of their shareholders (the principals) (Koch & Schmidt, 2010). Similarly, manipulating earnings may result in inevitable undesirable repercussions for shareholders as, for example, managers seek to claim the reaching targets imposed by influential stakeholders (Desai, Hogan, & Wilkins, 2006; Zahra, Priem, & Rasheed, 2005). To avoid such potential risks, managers often reward stakeholders by disclosing social and environmental information alongside their compliance with Corporate Governance (CG) regulations (Gargouri, Shabou, & Francoeur, 2010; Prior, Surroca, & Tribó, 2008). This argument suggests that firms with a high degree of ACD\_Q and strict compliance with CG rules are less likely to adjust their reported earnings.

Secondly, stakeholder theory proposes that managers take a broader set of stakeholders' interests into account during the decision-making process (Jensen, 1993; Lu & Abeysekera, 2017). The logic is that they should abstain from any ethically questionable behaviours, such as EM, in conjunction with projecting an ethically responsible image, in this case via ACD, in order to avoid potential conflicts with key stakeholders (Kim et al., 2012). This means that corporate involvement in ACD is connected with adherence to sound corporate governance measures, which together are anticipated to improve the quality of reporting and inform important stakeholders (AlHaddad & Whittington, 2019). Thirdly, legitimacy theory suggests that businesses should conduct economic operations in accordance with understood societal norms and prospects. According to Archel et al. (2009), one of the fundamental tenets of



conventional legitimacy theory is that there exists a social contract between business and society, to which adherence obligates organizations to act with the "legitimacy" and authenticity required to retain their license to operate, as well as their continuing use of social resources (Deegan, 2002; Owoeye and Pijl., 2016; Shocker & Sethi, 1973). Hence, businesses engage in a variety of ethical behaviours to establish and sustain their legitimacy, including adherence to CG frameworks (Cho & Patten, 2007; Cohen, Dey, & Lys, 2008). According to legitimacy theory, a company's involvement in ACD may be related to meaningful reporting of profit-related metrics to influence and manage society's perception of a positive image (Sun et al., 2010).

Therefore, we employ a multi-theoretical framework, which comprises agency theory, stakeholder theory, and legitimacy theory, in order to formulate our hypotheses and explain the emerging finding. All three theories posit differing logics for pursuing ACD\_Q and for wariness in deploying EM.

### **3. HYPOTHESIS DEVELOPMENT**

Previous research has provided insights into the ACD\_Q-EM nexus but still leaves gaps in both evidence and understanding. Table 1 below presents prior studies that have focused primarily on reviewing anti-corruption disclosure. It shows that previous studies limitedly focused on factors influencing ACD\_Q ( see Islam et al.,2015; Islam et al., 2016; Joseph et al., 2016; Blanc et al., 2017b; Barkemeyer et al.,2015; Healy and Serafeim, 2016; Blanc et al., 2017). Hence, there is no extant study examining how ACD\_Q influences EM. A few studies related to Environmental, Social and Governance Disclosure (ESGD) have assessed the relationship between different areas of ESGD and EM (Gerged et al.,2020; Kim et al., 2012; Velte, 2019; Liu et al., 2017; Pyo & Lee, 2013). These studies were focused on examining the CSR

Disclosure (CSRD)-EM nexus in a variety of developed and developing economies, including the United States, South Korea, the UK, Bangladesh, Jordan, and Kuwait (Kim et al., 2012; Gerged et al., 2020; Liu, Shi, Wilson, & Wu, 2017; Pyo & Lee, 2013; Sun et al., 2010; Velte, 2019; Cho & Chun, 2015; Choi et al., 2013; Gras-Gil et al., 2016; Garcia-Sanchez and Garcia-Meca, 2017; Muttakin et al., 2015; Suteja et al., 2016).

### **INSERT TABLE 1 HERE**

Nevertheless, there is no attention has been paid to the ACD\_Q-EM nexus (Islam et al., 2016; Barkemeyer et al., 2015). Thus, our study extends prior research by examining the direct association between ACD\_Q and EM and whether this association is contingent on audit quality in the UK.

Specifically, contributes to the current literature in various ways. First, we empirically examine how ACD\_Q affects EM in the UK after the introduction of the UK Bribery Act in 2010. Second, by covering a period span from 2008 to 2019, we examine the possible link between UK CG reforms and reducing EM. Finally, we evaluate the moderating influence of audit committee mechanisms on the ACD\_Q and EM link in the UK for the first time.

#### *3.1. Anti-corruption disclosure and earnings management*

As Table 1 shows, although there is no one study which directly examines how ACD\_Q is associated with EM, a few prior studies related to ESGD have assessed the association of different areas of ESGD and EM (Gerged et al., 2020; Kim et al., 2012; Velte, 2019; Liu et al., 2017; Pyo & Lee, 2013). For instance, Velte (2019) found that ESG performance negatively influences the Accruals Earnings Management (AEM) of German firms over the period from 2011 to 2017. Likewise, Patten and Trompeter

(2003) indicate that corporate environmental disclosure (CED) is negatively associated with AEM among a sample of US chemical firms, where managers believe that CED can be used to reduce a company's exposure to political and societal pressures. Similarly, using an international sample, Bozzolan et al. (2015) found that firms engaging in CSR practices are less likely to engage in REM than in AEM. Additionally, Kim et al. (2012) find that socially responsible firms in the US are less likely to engage in aggressive EM through discretionary accruals in an attempt to manipulate operating activities and then risk Securities and Exchange Commission (SEC) investigations.

Furthermore, Yip et al. (2011) examine whether CSR is related to earnings management in a sample of publicly listed US oil and gas and food companies. They find a positive relationship in the food industry and a negative association in the oil and gas industry between CSR and EM. They conclude that the relationship between CSR disclosures and earnings management is context-specific and influenced by the political environment of a firm rather than by ethical considerations alone. On the other hand, Prior et al. (2008) found a positive relationship between CSR and EM worldwide. They argue that managers who manage earnings figures for private benefit have incentives to engage in CSR activities, as these constitute a powerful tool for avoiding stakeholder pressure. More recent research by Velte (2019) suggested that ESGD negatively influences earnings management.

Anti-corruption disclosure includes efforts and procedures that fit with the 2010 Act and shareholder expectations. As a result, when managers participate in this activity, they may be expected to also exercise restraint in managing profits and making prudent operational choices, raising financial reporting transparency. In theory, if uncovered, EM could negatively affect corporate executives (Prior et al.,

2008). Thus, executives may seek to mitigate potential penalties and compensate stakeholders by publishing information about their environmental stewardship performance accompanied by reputable earnings figures as a strategy to be perceived as ethically responsible (Gargouri et al., 2010). As a result, the first hypothesis to test in our study is:

***H1. There is a negative relationship between ACD\_Q and EM.***

***3.2. The Audit quality -ACD\_Q nexus: AC moderating effect on the Audit quality-EM relationship***

According to DeAngelo (1981), audit quality is the combined likelihood of identifying and reporting financial statement problems, which depends on the auditor's independence, amongst other factors. Higher-quality auditors are thought more likely to uncover and disclose errors and inconsistencies because they should be less willing to tolerate questionable accounting practices. Prior research has shown that qualified auditors are more effective at restraining AEM, i.e., they limit managers' accounting flexibility. As a result, improved audit quality may be linked to higher genuine earnings management levels among enterprises with earnings management incentives.

This paper investigates ACD textual features, particularly their tone and their link with EM quality. Audit committee independence, audit firm rotation or tenure, audit committee expertise, and audit fees have all been linked to some occasions of earnings management and higher profit quality (Becker et al., 1998; DeAngelo, 1981; Gul et al., 2009).

Previous research by Bedard et al. (2004) and Carcello et al. (2006) found that having at least one person with financial competence on the audit committee is linked to a lower risk of damaging EM. According to Marra et al. (2011), the audit committee's financial expertise is also negatively linked to earnings management. To improve the

audit committee's efficacy in monitoring discretionary accruals, members of the audit committee need to have a high level of financial sophistication.

The majority of the audit committee members must be independent directors or non-executive directors for the committee to be truly independent and functional. According to Carcello et al. (2006), independent audit committee members with financial skills are more effective in mitigating EM. The audit committee's independence and EM have therefore delivered varied results. Therefore, we are motivated to investigate further the nexus between the audit committee independence and EM in the UK setting.

Depending on the country, auditor rotation has been controlled for a shorter number of years. For example, in the United States, the Sarbanes-Oxley Act reduces an auditor's employment duration from seven to five years. According to Kinney and Libby (2002), there is a negative relationship between auditor tenure and abnormal accruals in total value; Myers et al. (2003) find the longer duration of an auditor reduces likely AEM. For durations longer than seven years, Manry, Mock, and Turner (2008) found that audit tenure increases audit quality with smaller audit firms and partners. In contrast, others found that having a long-serving auditor reduces audit quality (Carey & Simnett, 2006). Hence, on balance, we posit a negative association between audit tenure and audit quality in the UK.

Finally, a higher audit cost/fee indicates a higher audit quality, either due to increased audit work or skill (Francis, 2004). According to Copley (1991), auditors who have invested more in reputation capital have a stronger incentive to adjust questionable accounting in order to provide value for stakeholders. The audit is not a homogeneous service in this regard, and variances in quality will be, as such, reflected

in audit costs/fees. For example, Francis (2004) revealed evidence that audit firms charging greater prices on average produced higher audit quality. Based on the given discussion, the following hypothesis is formulated:

***H2.*** *There is a negative relationship between audit quality and EM.*

***H3.*** *The relationship between ACD\_Q and EM is contingent on audit quality.*

## **4. RESEARCH DESIGN**

### *4.1. Consideration of Data and Sample*

Although the UK's ranking in terms of corruption has recently improved due to the Bribery Act, incidents, such as the scandal of phone hacking, have revealed that there are numerous areas in the UK's public sector where corruption can still happen (Dikmen and Çiçek, 2022; Hyvärinen et al., 2017). This has motivated us to shed light on the consequences of corporate engagement in an-corruption-related transparency in the UK. Consequently, our sample selection commenced with all companies listed in the FTSE 350 index, which reflects 96 per cent of the UK equities market and are considered the UK market leaders over eleven years from 2008 to 2018 (Habbash et al., 2013; Owusu et al., 2022). In order to ensure the validity of our outcomes and determine the association of legislation with corruption disclosure, a long time series covering the period of pre-and post-adoption of the 2010 UK Bribery Act by the UK firms is considered. Our financial data is gathered from DataStream and Orbis Bank Focus database. In contrast, the anti-corruption disclosure data and the moderator variables are manually extracted from firms' annual reports to avoid any data inconsistencies and unavailability. Financial institutions were excluded from the scope of our sample due to the particular features of their financial statements and regulatory requirements. Firms with incomplete data are excluded from the analysis to ensure

the generalization of the study findings. This results in a final sample of 2695 firm-year observations.

#### *4.2. Anti-corruption Disclosure Quality Measurement*

It has been argued that the choice of quality measure is significant and that focusing just on the volume of the disclosure can be misleading (Helfaya and Whittington, 2019; Hooks and Van Stadan, 2011). This viewpoint is supported by research that assesses the quality of disclosure in a variety of ways, often using a weighting method (i.g, Al-Shaer and Zaman, 2018; Beretta & Bozzolan, 2004; Bozzolan, O'Regan, & Ricceri, 2006; Guthrie & Parker, 1990; Hooks et al., 2011; Hasseldine et al., 2005; Salem et al., 2020). In this study, we have constructed an anti-corruption disclosure index based on both the 2010 UK Bribery Act and previous Anti-Corruption Disclosure (ACD) literature (e.g., Blanc et al., 2017; Ghazwani et al., 2023; Hooks and Van Stadan, 2011; Nobanee et al., 2020). Our index comprises both the width and depth of released information and is used as a proxy for the “richness” of anti-corruption disclosure. Specifically, it has various segments identifying the various categories or fields to which each ACD element belongs. Initially, a preliminary checklist containing the anti-corruption information items covered by the 2010 UK Bribery Act was developed. The checklist is compatible with other worldwide anti-corruption measures that require firms to declare their anti-corruption action (e.g. UNCAC, WB, OECD, GRI)., was developed. Our checklist consists of 25 anti-corruption information elements in six broadly defined categories: proportionate procedure (9 items); top-level commitment (5 items); risk assessment (3 items); communication, including training (3 items); due diligence) (3 items); and monitoring and review (2 items). Appendix 2 shows how each category is further broken down into a set of different informational items or topics. Following Salem et al. (2020), Ghazwani et al., (2023) and Hughes et al. (2001), we

utilised a scoring scale (a 5-point scale) that allows us to be able to differentiate between excellent and poor disclosures. For instance, we allocate the highest score, 4, for extraordinary disclosure, including evidence of targets, performance measurement against targets, and the previous years' benchmarking of best practices. Furthermore, we used multiple independent coders to verify the validity and reliability of the scoring procedure adopted for the disclosure index. Then, the variation of the coding scores was reviewed, compared and resolved accordingly. We applied Hughes et al. (2001) scale formula for our independent variable as follows:

$ACD\_Q = (1/\text{sum number of items}) * (\text{total of weighted scores for each item in the index}).$

The disclosure carried a weight of five, where 4 is assigned to extraordinary, benchmarking against best practises, 3 is given to quantitative, anticorruption impact clearly defined in monetary terms or actual physical quantities, 2 is assigned to descriptive, the impact of the company or its policies clearly evident, 1 is given to minimum coverage, little detail using general terms, anecdotal, or brief mentions, and zero is assigned to not disclosed or no discussion of the issue. Additionally, we adopt the Cronbach  $\alpha$  method to assess our anticorruption disclosure inter reliability and consistency (Bland & Altman, 1997). The outcome is consistent with a dependability level of 0.81, which is regarded as an acceptable degree of anticorruption disclosure.

#### 4.3. *Earnings Management Measurement*

Following previous studies (Bona-Sánchez et al., 2011; Gergedet al, 2021; Lakhal et al., 2015; Pelucio-Grecco et al., 2014; Sun et al., 2011; Usman et al., 2022a; Usman et al., 2022b), the discretionary accrual is employed as a proxy for earnings management (EM). Consequently, Kothari et al.'s (2005) Model is used to capture EM as it is the most effective and reliable in measuring EM compared with the modified Jones model (1991) (Sun et al., 2010; Usman et al., 2022c). Kothari et al.'s (2005) Model considers firms' performance (Return on Assets - ROA) in the current year as a control variable for any extreme operating performances, which the modified Jones



model has neglected. Following Kothari et al. (2005), a cross-sectional regression each year is used to estimate the abnormal accruals. Accordingly, we adopted the below model to measure EM;

$$\frac{TACC_{it}}{TA_{it-1}} = \alpha_0 + \beta_1 \frac{1}{TA_{it-1}} + \beta_2 \frac{\Delta REV_{it} - \Delta REC_{it}}{TA_{it-1}} + \beta_3 \frac{PPE_{it}}{TA_{it-1}} + \beta_4 ROA_{(it)} + \varepsilon_{it} \quad (1)$$

Where,  $TACC_{it}$  is the total accruals calculated by subtracting the firm's net income before unusual items for the year from cash flows from operations, deflated by the firm's total assets at the end of the year.  $TA_{it-1}$  is the book value of the total assets of firm  $i$  at the end of year  $t-1$ .  $\Delta REV_{it}$  is the revenues of firm  $i$  in year  $t$  subtracted from revenues in year  $t-1$ .  $\Delta REC_{it}$  is the change in accounts receivable.  $PPE_{it} / TA_{it-1}$  is the gross property, plant and equipment of firm  $i$  at the end of year  $t$  scaled by  $TA_{it-1}$ .  $ROA_{it}$  is earnings before extraordinary items scaled by lagged total assets.  $\alpha \beta_1 \beta_2 \dots$  are estimated parameters, whereas  $\varepsilon_{it}$  is the residual and the absolute values of this residual that is employed as a proxy for discretionary accruals.

#### 4.4. Audit quality measurement

It has been argued that auditors must have the skills, knowledge and other abilities required to accomplish their respective tasks (Prawitt et al., 2009). Experienced and knowledgeable auditors are more likely to recognise indicators of management bias in accounting accruals and how it may be mitigated (Cohen et al., 2008). In addition, managers will be less motivated to aggressively manipulate earnings if they have cause to believe that a competent audit committee is scrutinizing their accounting decisions (Prawitt et al., 2009). The vast majority of previous audit quality literature (Abbott et al., 2004; Al-Shaer and Zaman, 2018; Agrawal and Chadha, 2005; Bruynseels and Cardinaels, 2014; DeFond & Zhang, 2014; Francis, 2011; Ghafran

and O'Sullivan, 2017; Gerged et al., 2020; He and Yang 2014; Komal et al., 2021; Raimo et al., 2021; Salem et al. 2021; Salem et al., 2022; Quick and Schmidt, 2018) appears to employ audit fees, audit firm rotation, audit committee independence, joint audits and audit committee expertise as proxies for audit quality. Consequently, To examine our research expectation, this study used the most common proxies for audit quality, including audit committee independence (ACI), auditor firm rotation (AIR), audit committee expertise (ACE) and audit fees ratio (AFR).

Our study used a range of control variables that may influence the association between anticorruption disclosure and earnings management. In line with previous research, board diversity (Mohamad et al., 2011; Ezeani et al., 2022), the board size, board meetings (Vafeas, 2005), and board expertise (Ghafran and O'Sullivan, 2017) are used as control variables. Additionally, a set of firm-specific characteristics are utilized to mitigate any potential endogeneities caused by missing variables, including firm size (Khasanah and Kusuma, 2020), profitability (Ghafran and O'Sullivan, 2017), leverage (Khasanah and Kusuma, 2020) and Market to book value (Gerged et al., 2021). Appendix 1 shows the description and measurement of the study variables. The specified model (1) is employed to investigate the moderating role of audit quality in the relationship between anti-corruption disclosure quality and earnings management:

$$EM_{it} = f(ACD\_Q_{it} + A\_Q_{it} + CG_{it} + Firm\ characteristics_{it} + \varepsilon_{it}) \quad (2)$$

Where  $EM_{it}$  represents the earnings management proxy,  $ACD\_Q_{it}$  is anticorruption disclosure quality,  $A\_Q_{it}$  and  $CG_{it}$  are the audit quality and corporate governance proxies, respectively.

We employed the Generalized Method of Moments (GMM) and panel regression to achieve consistent estimates. In addressing any conceivable bias in a

dynamic panel, a GMM estimator is employed (Arellano & Bond, 1991; Roodman, 2006). Recently, a number of corporate disclosure studies have used the GMM estimator since it is intended to address weighted sample moment conditions (Alhazaimeh et al., 2014; Ezeani et al., 2021; Issa et al. 2021; Kouki, 2021) and fits with a wide range of explanatory factors that are less likely to be strictly exogenous and linked to current realizations of inaccuracy (Kim et al. 2014). As a result, a two-step GMM model is used to maximize estimation reliability by reducing issues caused by underpowered instruments and preventing proliferation (Blundell and Bond 1998; Dhaliwal et al. 2011). However, in the first step, the dynamic model (2) is used in its first-differenced format to avoid any potential bias caused by hypothetical omitted variables and time-invariant unobserved heterogeneity. The second step involves the one-year lagged values, “historical values”, of explanatory variables, which are used as instruments to address potential endogeneity problems by dynamically modifying the data as the prior year's value of a variable is eliminated from its present value (Wintoki et al., 2012; Roodman, 2006). The instruments employed in the main model (2) are considered valid since there is no correlation between the study variables and the error. Additionally, to evaluate the accuracy of the dynamic GMM estimator and whether the instruments utilized are appropriately specified, the Arellano-Bond test and the Hansen test are adopted. These tests appear insignificant, implying that our instruments are exogenous and legitimate and that the dynamic GMM model is a suitable estimator to address the possibility of endogeneity problems.

Additionally, the Chow test was used to compare the pooled and panel regressions (Rezaee and Tuo, 2019; Salem et al., 2021). The Chow test reveals that F statistics is significant at the 1% level, suggesting that panel data regression is the most appropriate for our dataset. The Hausman specification test was also used to examine

the appropriateness of using either random or fixed effects regression. The Hausman test confirms that the fixed effect was the most effective for our sample, with a Prob>chi2 value of 0.0109. The fixed effects approach offers the benefit of reducing the influence of confounding factors as long as they are consistent throughout time (Firebaugh et al., 2013).

## **5. RESULTS AND DISCUSSION**

### *5.1. Descriptive statistics and correlation analysis*

The descriptive statistics of the study variables are shown in table 2. The mean value of Abs\_DACC as a proxy for earnings management is almost 6% which differs from its minimum value of 0 and maximum value of 64% with a standard deviation of 25%. This finding is in line with recent UK studies such as Habbash et al. (2013) and Sun et al. (2010), with mean values of 6.9% and 6.4%, respectively, signifying that the model fits the dataset reasonably well. For ACD\_Q, the mean value is 11%, with a maximum value of 44%. The low value of ACD\_Q might be ascribed to the slow initial take-up of UK firms' adherence to the Bribery Act. This result, however, is consistent with those reported by Álvarez Etxeberria and Aldaz Odriozola (2018) at 10%, Barkemeyer et al. (2015) at 11% and Nobanee et al. (2020) at 12%.

Concerning the audit quality, the mean value of ACI is 81%, which suggests that the high level of independence in the audit committee should promote effectiveness in financial reporting and mitigate EM practices (Song and Windram, 2004). Regarding AIR, the average value is 6.5 years, indicating that most UK firms comply with existing statutory regulations since the legal regulations state that firms should rotate the audit firms within 10 to 24 years (Quick and Schmidt, 2018). The results demonstrate that AIR may promote financial statement users' perceptions of audit quality which could be a useful regulatory tool for regaining public trust in capital

markets (Song and Windram, 2004). The mean value of ACE is 6, which is inconsistent with Ghafran and O'Sullivan (2017), which reported a lower mean value of audit committee members (3.4) among a sample of FTSE 350. As Ghafran and O'Sullivan (2017) were confined to the 2007-2010 period, the high mean value of ACE in our study could be attributed to the recent requirement by the International Auditing and Assurance Standards Board (IAASB) in January 2015 to hire more experienced members for the audit committee (Lawson et al., 2017). This is also evidenced by a more comparable average of ACE reported by international firms post the recent IAASB requirement. For example, Quick and Schmidt (2018) indicate that the average value of audit committee expertise in German firms is 5.4.

Furthermore, the mean value of AFE is 1.4 and consistent with Abdelfattah et al. (2021), who found that the average value of audit fees in UK firms is 1.8.

In addition, Table 2 presents the indicator variables which are used to control for the joint effect between the relationship between ACD\_Q and EM. The mean values of BD, BZ, BM and BEX are 22%, 8.8, 7.9, and 10.1, respectively. These outcomes are in line with Elmagrhi et al. (2017), Gerged et al. (2021) and Katmon and Farooque (2017).

## **INSERT TABLE 2 HERE**

Tables 3 and 4 report the correlation matrix and variance inflation factor of the variables used in the main module to test the assumption of multicollinearity, respectively. The coefficients on Pearson correlations and variance inflation factor illustrate that there are unlikely to be any statistical issues arising from multicollinearity since the coefficients and VIF values are considerably low in our model (maximum VIF value is 1.4) (Gujarati and Porter 2009).

## INSERT TABLES 3 and 4 HERE

### *5.2. Anti-corruption Disclosure and Earnings Management*

Table 5 offers several sets of tests to investigate the association between ACD\_Q and EM (Models 1 and 2), as well as the mediating effect of audit quality (Models 3 and 4). The results of a fixed-effects model (1 and 3) were complemented by running a GMM model (2 and 4), which corrected the effects of autocorrelation and controlled for unobservable heteroscedasticity. Since the largest variance inflation factor (VIF) is 1.49, multicollinearity should not be a serious statistical issue. The results of all models presented in Table 5's document that ACD\_Q has a negative and significant influence on EM at a 1% level, indicating that UK firms who disclose ACD\_Q are less unlikely to be involved in EM. This result might be simply that ACD\_Q is influenced by managers' desires to be ethical, trustworthy and honest in an attempt to legitimate their operations and improve their chances of survival (Kim et al., 2012). These findings are in line with the suggestion that accountable, transparent, and socially responsible firms are highly unlikely to engage in irresponsible behaviours such as EM practices across a sample of UK firms (Chih et al., 2008; Gerged et al., 2021; Hong & Andersen, 2011; Khasanah and Kusuma, 2020; Sun et al., 2010). It would seem UK firms with high ACD\_Q involvement appear to be more conservative in their financial decisions, offering more reliable earnings information to the public (Gerged, Al-Haddad, & Al-Hajri, 2020). As a consequence, our findings have statistical support for the first hypothesis ( $H_1$ ).

With regards to audit quality, table 4 shows that ACI and ACE have a negative and significant association with EM at a 1% level throughout all four models. On the contrary, we found no statistically significant links for AIR or AFR with EM. This finding suggested that independent audit members with a high level of financial experience are able to conduct effective monitoring, which enhances the audit quality and limits

EM involvement. This gives limited credibility to **H<sub>2</sub>**. This result is consistent with the assumption that independent audit committees with audit expertise boost trust in the accuracy of financial reporting and reduce the extent of EM manipulation. In line with previous studies, this outcome confirms that the inclusion of experienced and independent directors on the audit committee increases the company's value, reinforces monitoring responsibilities (Mangena and Taurigana, 2008), decreases managers' opportunistic behaviour (Salem et al., 2021), and thus, restrain earnings manipulation (Zgarni and Zehri, 2016). On the other hand, the positive and insignificant association of AIR and AFE with EM suggests that the fees paid to the auditors and auditor tenure can weaken auditor independence, increasing the likelihood of managers engaging in EM. This outcome is consistent with those reported by Chung and Kallapur (2003) and Gul et al. (2007).

Interestingly, the utilized control variables have a variety of associations with EM, even though this is not the focus of this study. For instance, BEX has a negative and significant association with EM, signifying that expert directors have the intention to curb EM. Similarly, Park and Shin (2004) found that directors with financial experience can successfully minimize EM. Additionally, ROA as a proxy for profitability has a negative and significant influence on EM, implying that directors of firms with a high level of profitability are unlikely to engage in EM (Salem et al., 2021).

### *5.3. The Mediating Role of Audit Quality in the ACD\_Q and EM nexus*

We employed the interaction of ACD\_Q with audit quality proxies to examine the mediating effect of audit quality on the ACD\_Q and EM nexus. Mainly, model (2) is re-regressed with an inclusion of the ACD\_Q\*ACI, ACD\_Q\*AIR, ACD\_Q\*ACE and ACD\_Q\*AFE to determine the potential moderating effect of audit quality on the

ACD\_Q and EM nexus. The interaction models 3 and 4 presented in Table 5 demonstrate a negative and significant role of ACD\_Q\*ACI and ACD\_Q\*ACE in the association between ACD\_Q and EM at a 1% level, suggesting that companies that reveal more information about corruption and bribery with independent and expert audit members tend to act ethically and are unlikely to falsify earnings. This result is similar to those of Putri and Suputra (2019), who reported that audit quality has a moderating role in the relationship between corporate disclosure and EM. Additionally, although the coefficients of ACD\_Q\*AIR and ACD\_Q\*AFE are negative, they do not significantly affect the relationship between ACD\_Q and EM. In other words, some audit quality proxies can improve ACD\_Q's capacity to explain differences in EM when compared to directly investigating the ACD\_Q-EM nexus. This finding implies that (*H3*) is experimentally supported, adding a significant and new contribution to existing ACD\_Q studies.

#### **INSERT TABLE 5 HERE**

##### *5.4. Additional sensitivity analysis*

Since anticorruption disclosure is voluntary in most developed and emerging economies, stakeholders are increasingly demanding companies address social concerns and release more information about corruption issues. For instance, in order to fulfil public expectations, the UK government tends to create a strong demand for firms to report relevant corruption information (Islam et al., 2021). Furthermore, it has been argued that the level of anti-corruption disclosure is a valid indication of the completeness and integrity of a company's strategy to fight against misconduct (Transparency International, 2009). Therefore, it is critical to check and gain confidence in our analysis by investigating further the link between ACD\_Q and EM. As a result, we investigate whether the influence of ACD\_Q on EM differs before and



after the legal enforcement of the UK Bribery Act 2010. We divided the sample into two subgroups (before and after the UK Bribery Act), using 2011 as a cut-off point. A random-effects model supplemented with a fixed-effects model was adopted to adjust for unobservable company heterogeneities over time. Although the findings in Table 6 illustrate that firms correlated with ACD\_Q are less likely to engage in EM at a 1% level following the introduction of the UK Bribery Act, the relationship appears to be weak before 2011. It also shows that the moderating role of both ACD\_Q\*ACI and ACD\_Q\*ACE in the ACD\_Q-EM nexus remains unchanged. This supports the argument that government legislation with an effective audit committee has a robust mechanism in convincing firms to provide more anticorruption information to stakeholders (Joseph et al., 2016), which in turn minimizes EM practice. This outcome confirms the main result presented in Table 5.

Furthermore, we examine the validity of the core findings by utilizing the frequency of anticorruption disclosure (ACD) as a substitute proxy for ACD\_Q to investigate whether the new proxy reduces or increases EM. We claim that, notwithstanding the inseparability of the quantity and quality of corporate disclosure, evaluating corporate disclosure efforts solely on their quantity may enhance market judgments (Salem et al., 2020). In this respect, the content analysis approach is utilized to extract the anticorruption disclosure (ACD) quantity, and the primary analysis is performed (Belgacem and Omri, 2015). Previous research has widely employed content analysis in corporate disclosure studies due to its ability to produce valid results for a variety of items (e.g., messages, lines, text, keywords, and or sentences) (Lopatta et al., 2017; Masud et al., 2019; Salem et al., 2020). The index was developed from significant disclosure indices in the environmental accounting literature and created specifically for our research context. In establishing our index, a

wide range of rules on corruption and bribery, including; OECD, World Bank, UNCTAD<sup>1</sup>, UNGC<sup>2</sup>, UNCAC<sup>3</sup>, and GRI,<sup>4</sup> were also taken into account. Several steps were taken into account to assess the validity of our measurement, including; the checklist created using pertinent research findings, an analysis of global trends, and observations of typical reporting practices. We also double-checked the accuracy of our measurement by various coders scoring the study instrument (Salem et al., 2020). In addition, we compared and resolved the differences between coders in line with previous studies (Salem et al., 2020; Alotaibi and Hussainey, 2016). The level of words was utilized to capture specific and detailed information about ACD since it lends itself to a more comprehensive and in-depth examination. Following Salem et al. (2020), the number of words is modified by firm size since this external element has been shown to influence the degree of disclosure. Using OLS regression and subtracting the residual from the actual total frequency of revealed items, we computed the standardized level of disclosure. The minimum and maximum values of revealed items from the whole sample are then utilized to find out the amount of ACD. Table 7 displays the additional sensitivity analysis that was performed using quantity as a proxy for ACD\_Q. We discovered that the frequency of anticorruption disclosure (ACD) had a significant link with EM at a 1% level. Table 7 further showed that the moderating<sup>5</sup> influence of ACI, ACE and AFR on the correlation between quantity-ACD and EM nexus remained intact. Our results reliably back up the primary finding, demonstrating that both the level and quality of anti-corruption disclosure are likely to boost financial reporting transparency and decrease EM.

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1 The United Nations Conference on Trade and Development

2 The United Nations Global Compact

3 The United Nations Convention against Corruption

4 Global Reporting Initiative

<sup>5</sup> We used the quantity instead of quality for the interaction variables to be consistent with the main regression presented in Table 5

## INSERT TABLES 6 and 7 HERE

### 5.5. Robustness test

A classification shifting model is employed to assess the robustness of the key findings to different earnings management measures. Following Usman et al. (2022) and Zalata and Roberts (2016), we used the below model to capture earning management:

$$UEC\_E = \alpha_0 + \alpha_1 N\_RI + \alpha_2 FS\_E_t + \alpha_3 C\_FO_t + \alpha_4 L\_EV_t + \alpha_5 ROA_t + \alpha_6 BT\_M_t \quad (3)$$

**Where;**  $UEC\_E$  is the unexpected core earnings and is derived by subtracting the reported core earnings from the expected core earnings scaled by sales. The  $N\_RI$  is the non-recurring item and is calculated as core earnings less bottom-line earnings scaled by sales. The firm size ( $FS\_E$ ), operating cash flow ( $C\_FO$ ), leverage ( $L\_EV$ ), return on assets ( $ROA$ ) and book-to-market value ( $BT\_M$ ) were used to control for the potential influence on classification shifting (Usman et al., 2022; Zalata and Roberts, 2017).  $FS\_E$ : Natural logarithm of total assets,  $C\_FO$ : Cash flow from operations scaled by lagged total assets,  $L\_EV$ : Total liabilities scaled by total assets,  $ROA$ : Net income scaled by average total assets,  $BT\_M$ : Total assets scaled by market capitalisation.

We included both  $UEC\_E$  and  $N\_RI$  in the main model (2) and re-run fixed and GMM regressions to examine whether there is a relationship between classification shifting and  $ACD\_Q$ . As expected, Table 8 shows that there is a positive and significant association between  $UEC\_E$  and  $N\_RI$ , signifying that managers shift recurring expenditures to the income statement as non-recurring expenses in order to boost core profitability and consistent with those of Zalata and Roberts (2017) and Usman et al., (2022). In addition, Table 8 illustrates that our main findings are robust to alternative earnings management proxies.

## INSERT TABLE 8 HERE

Prior research has demonstrated that managerial choices influence both corporate disclosure and earnings management, potentially leading to endogeneity problems (Rezaee and Tuo, 2019; Salem et al., 2020). As a result, Durbin-

WuHausman is conducted to investigate whether our model has an endogeneity problem. The result of Durbin-WuHausman is 0.1264, indicating that there is no endogeneity issue between the study variables. Following Salem et al. (2020), we considered ACD\_Q as an endogenous variable, which means that an endogeneity analysis will determine the outcome. Our study employed instrumental variable estimation (L\_ACD\_Q)<sup>6</sup>. To reassess the key findings, The two-stage least squares technique is used. The results in Table 9 are qualitatively consistent with those presented earlier in Table 5. Nevertheless, our tests supported the robustness of the major findings and were unaffected by the possibility of endogeneity issues.

#### **INSERT TABLE 9 HERE**

## **6. CONCLUSION**

When considering theoretical claims that audit quality usually drives or controls the choice to reveal information about anti-corruption disclosure activities and to engage in EM, the prior evidence on why and how audit quality moderates the ACD Q-EM nexus is scarce. Consequently, our study investigates the critical issue of how and why a corporation's ACD\_Q may be correlated with its participation in EM and whether audit quality could moderate this relationship in developed economies, such as the UK. By doing so, our study makes three principal contributions: (i) it is the first to examine the direct relationship between ACD Q and EM in the developing world; (ii) it adds to the limited literature on the relationship between audit quality and EM; and, most importantly, (iii) it is the first study to examine the possible moderating influence of audit quality on the ACD Q-EM nexus.

Our results indicate that ACD\_Q is adversely linked with EM, implying that managers who reveal more information about ACD\_Q are less likely to engage in EM

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<sup>6</sup> Following Salem et al. (2020); Harris et al., (2019) and Choi et al., (2013) the lagged variable of anti-corruption disclosure is used as instrumental variable

in the UK. Corporations with a higher ACD\_Q might be said to be more cautious in their accounting judgments, offering more meaningful earnings information to stakeholders. These findings align with Kim et al.'s (2012) argument that ACD\_Q is motivated by managers' desire to be trustworthy, honest and ethical to legitimize their operations and improve their chances of survival. These findings highlight the need for more reforms in order to enhance reporting quality and reduce EM practices.

Crucially, the role of ACD\_Q in mitigating EM appears to be stronger following the legal enforcement of the UK Bribery Act and weaker before 2010. Furthermore, in the UK, various audit quality proxies (e.g., ACI and ACE) have a moderating influence on the relationship between ACD\_Q and EM. Our results are robust to alternative measures of the research variables and endogeneity concerns.

Our research evidence highlights the critical need for more coordinated actions by regional regulatory organizations and other governance bodies to create better enforcement arrangements for audit committee provisions, resulting in reduced EM for well-governed firms with high ACD\_Q. As a result, our empirical outcomes can assist policymakers and corporate executives in both developed and developing economies in successfully motivating firms to disclose more ACD\_Q, which is believed to be linked to reducing EM engagement at greater levels of company compliance with audit committee arrangements.

Although we have sought to make our findings both thorough and robust, several limitations should be noted. Firstly, the EM, ACD\_Q and audit quality data were manually gathered, which required significant time investment and limited our attention to a sample of UK-listed firms. Therefore, more research is needed to expand this analysis beyond a single nation setting and into a cross-country scenario that takes into account both bank-based and market-based economies. Secondly,

although our ACD\_Q SHI index captures the width and depth of released information, future researchers may enhance our study by using alternative ACD\_Q and audit quality proxies (e.g., sentences counted/pages and the KAM index). Finally, the investigation is limited to internal audits due to data constraints. Researchers should contribute additional insight in the future by exploring how and why external influences such as Big-4, national culture, legislation, politics, ownership structure and market pressures might alter the ACD\_Q-EM nexus in developed and developing countries. Financial services companies were not included in our study, and a comparative study of this one sector should also be of interest.

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