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The effect of using an external accountant on accounting quality

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Table of Contents

1. INTRODUCTION.....	1
2. LITERATURE REVIEW	2
2.1 INFORMATION ASYMMETRY	2
2.2 ACCOUNTING QUALITY.....	2
2.3 EARNINGS MANAGEMENT.....	3
<i>2.3.1 Motives for earnings management:</i>	3
<i>2.3.2 Size management</i>	4
<i>2.3.3 Identification of abnormal and discretionary accruals:</i>	5
2.4 TAX EVASION.....	7
2.5 CREDIT COST INCREASE.....	8
2.6 EXPERIENCE FROM NEIGHBOURING COUNTRIES.....	8
2.7 EXPERIENCE FROM NORWAY.....	9
2.8 KNOWLEDGE GAP	10
3. RESEARCH QUESTION	10
4 LIMITATIONS:	11
5 HYPOTHESES	11
6. DATA COLLECTION AND METHODOLOGY	12
7. PLAN FOR THESIS PROGRESSION.....	12
8. REFERENCES:.....	14

1. Introduction

The Norwegian statutory audit requirements were modified in 2011, in order to simplify regulations for small companies. New regulation exempted companies with revenue below 5 million, assets below 20 million and less than 10 employees from statutory audit (revl, 1999, §2-1; asl, 1997, §7-6). In the parliament proposal (Finansdepartementet, 2010) the Ministry of Finance argued that the proposed amendment would simplify the regulation for the smallest companies, equalize the treatment of companies with limited liabilities and be more aligned with international legislation. In Europe, the majority of countries have never had statutory audit requirements for small companies, or have implemented such exemptions in recent years. Neighbouring countries such as Sweden, Denmark, Finland and Great Britain had already implemented similar legislations in 2011.

A comprehensive evaluation of the amendment, requested by the Ministry of Finance, was completed in 2015 (Langli, 2015). The evaluation includes an analysis of the quality of financial statements and tax returns of opt-out companies, relative to audited companies. In general, the evaluation finds no signs of impaired accounting quality, but the formal quality of the tax returns has decreased. However, the decrease in quality is not seen in opt-out companies using an external accountant. The evaluation sample only includes two years post-amendment, and Langli notes that it is too early to conclude on long term consequences.

The goal of this paper is to explore the current literature on accounting quality and manipulation of financial reporting. In addition, we will identify research related to audit exemption thresholds and the implemented amendment in Norway. Further on, government regulations and standards related to the auditor's and accountant's role will be examined. Based on the literature review, we will identify methodology and limitations of current research relevant to our preliminary research question:

“Which effect does use of an external accountant have on accounting quality in small companies?”

2. Literature review

2.1 Information asymmetry

As defined by the International Accounting Standards Board, "The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions." (IASB, 1989, definition restated in IASB, 2010) However, the relevance depends on the users. The investor wants information on the potential return, the authorities needs to know if regulations are followed and taxes correctly estimated, while management needs a basis for internal control and target-setting. The conflict of interests makes it difficult to define the exact requirements of financial reporting, which presents an opportunity for misleading reporting by management. Hence, audits are used - either required by law or in the company's self-interest - to provide quality assurance to stakeholders.

International standardization of accounting standards has led to the development of a mutual conceptual framework by two of the most influential standard organizations, IASB (IFRS) and FASB (US GAAP). The new framework emphasize that the primary users of financial reporting are investors, lenders and other creditors (IASB OB2, 2010). In the same document, OB10 states that the reports are not primarily directed to other parties, such as regulators. This means that taxable income is decoupled from net income in financial statements, and companies are often subject to separate reporting to the tax authorities. The degree of consistency between these kinds of reporting is called book-tax conformity. In a study by Atwood, Drake & Myers (2010), the authors argue that increased book-tax conformity may reduce earnings quality. Nobes & Schwenke (2007) explores book-tax conformity in Norway, which is stated to be low.

2.2 Accounting quality

Also because of the aforementioned conflicts of interest, a general definition of accounting quality is difficult to find in literature. For the subject of this paper, we are influenced by Petersen & Plenborg's (2012, p. 334) characterization of good accounting quality: "financial statements that provide an objective (neutral) picture of a firm's financial position and is free of manipulation". We emphasize

that the act of manipulation does not need to be deliberate. The accounting quality can also be impaired as a result of inaccuracy or limited knowledge among the producers of the financial statements. Manipulation can be referred to as earnings management (Penman, 2013, p. 592). Earnings management is often associated with modification of accruals, nevertheless changes in capital structure and accounting methods can also be used to manage earnings (Schipper, 1989, p. 98; Jones, 1991, p. 206).

2.3 Earnings management

In accounting theory, earnings management is a much-researched subject and happen when either sales are inflated or expenses deflated in one period, and to be reversed in a later period, to make financial statements appear better. Healy & Wahlen has often been cited for their definition of earnings management in relation to standard settings:

Earnings management occurs when managers use judgements in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. (Healy & Wahlen, 1999, p. 368)

Earnings management is possible because accounting standards opens for individual judgement where standardisation would be too rigid and not necessarily reflect the true financial value. The judgement is often related to uncertain events such as expected life of fixed assets, future obligations and losses or future value of R&D and marketing.

2.3.1 Motives for earnings management

Healy & Wahlen (1999) presents three different main incentives for earnings management. First, earnings management can be motivated by influencing expectations of investors and capital markets to affect the value of the company. Dye (1988) presented how managers used earnings management to influence potential investors perception of the firm's value. Trueman & Titman (1988) explained how managers smooth income to cover the variance of the firm's underlying economic earnings. The authors theorize that this is because managers think that investors value firms with a smooth income stream higher. Burgstahler

& Eames (2006) found evidence for upward earnings management to avoid earnings below analysts' forecasts.

A second type of incentive to earnings management is to prevent violation of contracts. Financial figures are often used as specific terms in contracts such as debt covenants in a loan contract or management compensation programs. Managers who change accounting policies in order to avoid violation of debt agreements are documented in several studies. DeFond & Jiambalvo (1994) found evidence that suggests positive manipulation of financial accounts to avoid violation of debt covenants. The studied firms had positive abnormal total and working capital accruals in the year prior to the violation of the debt covenants. Sweeney (1994) documents a relationship between changing accounting practices as the firms are approaching the debt covenants constraints.

A third type of incentives for earnings management is related to government regulations, typically imposed by antitrust law or other specific industry concerns. Companies of a monopolistic nature (Cahan, 1992) or companies engaged in imports (Jones, 1991) could use income-reducing accruals to prevent unfavourable regulations. However, such government regulations are less relevant for small companies with limited importance for industry related or antitrust matters. A more relevant field of research for companies regardless of size are tax related regulations. Guenther (1994) found evidence of earnings management in relation to the Tax Reform Act of 1986 in the United States. The reform reduced the maximum corporate tax level from 46% to 34 %. The author found a significant level of negative accruals in the year prior to the tax rate reduction. In other words, the companies adjust accruals to reduce the profit in the year with the highest tax rate, then increase profits when the tax rate is reduced.

2.3.2 Size management

Another well-documented case of earnings management relates to specific threshold values. Burgstahler & Dichev (1997) examined the distribution of companies with around-zero earnings, and found a higher than expected proportion of companies just above zero. Although the authors are cautious with drawing conclusions based on their findings, the study illustrates that earning management is occurring around specific thresholds. Bernard, Burgstahler & Kaya (2014, working paper) expand on this subject by documenting size

management in companies close to audit thresholds in Europe. They theorize that companies manage earnings to adapt to the threshold levels in order to avoid audit. They find a higher concentration of firms just below the threshold values related to revenue, total assets or number of employees. As these results appear in several of the studied countries, it would be interesting to replicate the test on Norwegian companies.

Schipper (1989, p.101) emphasizes that research on earnings management must be interpreted with caution. Many empirical studies find indications of earnings management, but it might be difficult to document the incentives behind the management. In addition, results of earnings management research must be interpreted in light of the limitations and trade-offs made by the researchers. Results found under special circumstances, in specific geographic locations and of a limited number of observations cannot easily be translated to other contexts.

2.3.3 Identification of abnormal and discretionary accruals

The most common method of identifying earnings management is to analyse accruals. “An effective way to reduce reported earnings in a hard-to-detect manner is to manipulate accounting policies relating to accruals” (Scott, 2012, p.313). Accruals can be divided into discretionary and non-discretionary accruals. Discretionary accruals are determined by the management, while non-discretionary accruals are adjustments regulated by accounting standard-setting bodies (Healy, 1985, p. 89). Further, discretionary accruals are often classified as normal or abnormal. As stated by Healy & Wahlen (1999, p. 370), “To identify whether earnings have been managed, researchers first have to estimate earnings before the effects of earnings management”. The problem is that abnormal accruals are notoriously difficult to separate in the presence of earnings management. A solution, posited by Healy & Wahlen in the same paper, is to identify conditions where managers are likely to have strong incentives for earnings management, and test if the unexpected accruals are consistent with the incentives.

McNichols & Wilson (1988, p. 2) measures earnings management by looking at one specific type of accrual. Provisions for bad debts are compared with an estimate of normal accruals using GAAP. The motive for selecting this

particular accrual was to “attempt to isolate a discretionary accrual proxy that is substantially free of non-discretionary components”.

Instead of estimating only one discretionary accrual, Jones (1991) estimates the discretionary component of total accruals, a model often cited in academic literature (DeFond & Jiambalvo, 1994, p. 158; Dechow, Sloan & Sweeney, 1995, p. 198; Scott, 2012, p. 313). The author theorize that total accruals will capture a larger part of managers manipulation than one single accrual account. Also included are changes in revenue and fixed assets, in order to define non-discretionary accruals. The Jones’ model is based on previous research by Healy (1985) and DeAngelo (1986), but attempts to relax the assumption of constant non-discretionary accruals. Jones estimates non-discretionary accruals as follows:

$$NDA_{\tau} = \alpha_1(1/A_{\tau-1}) + \alpha_2(\Delta REV_{\tau}) + \alpha_3(PPE_{\tau})$$

where

ΔREV_{τ} = revenues in year τ less revenues in year $\tau-1$ scaled by total assets at $\tau-1$;
 PPE_{τ} = gross property plant and equipment in year τ scaled by total assets at $\tau-1$;
 $A_{\tau-1}$ = total assets at $\tau-1$; and
 $\alpha_1, \alpha_2, \alpha_3$ = firm-specific parameters.

Equation 1: Jones’ model

Dechow et al. (1995) presents a modified version of Jones’ model, adjusting the revenue component for change in receivables. This modification assumes that all change in credit sales comes from earnings management. Another version of Jones’ model was introduced by DeFond & Jiambalvo (1994), matching observations of firms from the same year and industry. Such cross-sectional regression relaxes the assumption of a constant coefficient related to year and industry. Kasznik (1999) introduced a further development of Jones’ model including modifications made by Dechow et al. (1995) and Defond & Jiambalvo (1994) and introducing change in operating cash flow as an explanatory variable.

Instead of estimating the non-discretionary accruals based on different determinants, Dechow & Sloan (1991) presents an industry model assuming that the variation of the determinants is similar for companies in the same industry. Later, Dechow & Dichev (2002) highlight the importance of the estimation error has on measurement of accruals and earnings quality. They claim previous research have too much focus on the unobservable intentional manipulation by

managers, and suggest accrual quality is systematically related to observable firm characteristics like volatility of operations.

2.4 Tax evasion

The terminology of deliberate tax adjustments differs in literature, and is often separated as technically legal avoidance and technically illegal tax evasion (Hanlon & Heitzman 2010, p.27). The authors argue that the legality is difficult to determine and use tax avoidance for all types of deliberate tax adjustments. For the subject of this paper, we use the general terminology, as we focus on tax evasions that are more clearly illegal than the Hanlon & Heitzman review.

Research on the link between tax evasion and audit exemption is limited, which may be due to different responsibilities of the auditor in Norway compared to the rest of the world (Langli, 2015, p. 260-261). While auditors in other countries generally have commitments toward investors and creditors, Norwegian auditors have an increased responsibility toward the Norwegian Tax Administration (NTA). Especially, the auditor is required to sign the tax return (Ligningsloven, 1980, §4-5; Skatteforvaltningsforskriften, 2016, §8-2-6). This requirement has led to a tax control framework based on the external audit, with a low frequency of tax audits performed by the NTA (Finansdepartementet, 2010, p. 28-29). Hence, tax evasion by opt-out companies will have lower chance of being discovered, *ceteris paribus*.

Langli (2015, 2016) has studied tax evasion after the implementation of the Norwegian opt-out amendment. The studies theorize that in the absence of an audit, businesses can keep sales off the books, or include personal expenses. Hence, net income should be lower in opt-out companies who engage in tax evasion. Langli's evaluation (2015) notes that tax evasion by opt-out companies has generally not increased, but there are some signs of increased evasion in at-risk sectors. In a following study, Langli (2016) finds no signs of tax evasion, even though it includes a longer time period (year 2006-2014).

In an attempt of designing an improved control system based on tax audits, Berset, Eide, Goldstein, Larssen & Olsen (2010) studies a sample of 467 Norwegian firms randomly selected for tax audit. Their results suggest that firms in the most centrally located municipalities evade more, while use of an external

accountant decrease tax evasion. However, the authors note that their sample is small, and the results are not conclusive.

2.5 Credit cost increase

From the creditor's point of view, the auditor plays a key role in validating the risk of issuing credit to a company. It is theorized that opt-out companies will have higher credit cost, due to a lack of an independent assurance of the financial statements. Blackwell, Noland & Winters (1998) studied a sample of small, private American firms, and found that the interest rate of audited firms were approximately 25 basis points lower than unaudited firms. Other research on this topic are conducted in the US by Allee & Yohn (2009), providing evidence on how auditing yields lower cost of credit by obtaining lower interest and financial cost from banks. Banks are using financial statements as leverage for evaluating risk and thus may find it safer to trust audited financial statements. In a study by Langli & Che (2016) however, no effects were found. The authors studied Norwegian companies before and after the audit exemption, and notes that the lack of effect could be because of a different business environment. For example, banks could be more likely to demand personal security for credit, which reduces the need for accurate financial statements.

2.6 Experience from neighbouring countries

Several European countries have implemented audit exemption thresholds prior to Norway. Due to geographical and cultural similarities, research conducted on neighbouring countries can be of interest. Denmark (2006), Sweden (2010), Finland (2005) and the UK (1994) had already implemented audit exemption for small companies (implementation year) when Norway introduced the amendment in 2011. In Denmark, the implementation has been evaluated five times by Erhvervsstyrelsen (2014) in the period of 2006-2011. The evaluations find that opt-out companies have more errors in their financial reporting, but many of the errors relate to the disclosure of the audit exemption itself. After correcting for this, the error rate approaches that of audited companies. In UK Dedman & Kausar (2012) found evidence of higher credit scores among companies which was audited than among the opt-out companies. They also found evidence of less

conservatism in the financial reports among opt-out companies relative to the audited companies.

2.7 Experience from Norway

The research and evaluation conducted on the effects of the amendment in Norway are few but extensive. On request of the Ministry of Finance, Langli (2015) evaluated positive and negative consequences of the amendment. The research included data from financial statements, tax returns, automatic and manual controls by the NTA, questionnaires and interviews. The evaluation covers primarily the period of 2006-2012 and the main findings are that the audit exemption affects a large number of companies but represent only a small part of the economy. The author finds no evidence of negative financing effects, but a net savings of approximately 20 000 NOK per opt-out company is found in 2012. The evaluation finds in general no signs of impaired accounting quality, but indications of less conservatism in the accounts among the opt-out companies. Specifically, the author finds indications of reduced accounting quality among the companies with the highest potential for earnings management. There is evidence of a clear decline in the quality of tax-returns among the opt-out companies, although this effect is neutralised if they use an external accountant. No indications of increased tax avoidance are found, but the NTA uses more resources on the opt-out companies. Langli notes that the audit market have not reached an equilibrium and it is too early to conclude on long term consequences.

In the Norwegian Official Report (NOU), nr. 22 from 2016, potential adjustments of the Limited Liability Companies Act (asl). §7-6 was evaluated, including the exemption of statutory audit of small companies. The committee was particularly asked to evaluate a potential increase of the thresholds. They agree with Langli's findings that the general effects of the amendment have been positive so far, but do not propose an increase of the current thresholds. They suggest a continuation of the current levels, supporting the original argumentation in Prop. 51 L (Finansdepartementet, 2010) of a higher need for auditing above current levels as the complexity of the companies increases. Companies included in a potential increase in the thresholds for revenue are largely identified to be in industries with a high risk of tax fraud.

2.8 Knowledge gap

Most of the studies on earnings management use listed companies, which makes it difficult to generalize the results to our case. There are several factors that might have implications. Especially, the relatively low audit exemption thresholds mean that our sample of companies will have different characteristics than previous studies. The proportion of companies with assets valued at management's discretion is smaller, and there is no easily available market value to benchmark against.

Another difference is that the management in small, privately held companies might have different motives than in listed companies. The management is often also the owner, which makes management-investor information asymmetry less of a problem. On the other hand, the asymmetry with other stakeholders, such as the tax authorities and creditors, can be increased.

As earlier mentioned, Norwegian regulations differ in an increased responsibility of the auditor for the correct reporting of taxes. In addition, the role of the external accountant is not directly comparable to other countries. This means that international research on audit is not immediately transferable to the Norwegian business environment.

Previous research on the Norwegian audit exemption has been limited to a few years post-amendment, and the authors have been careful about concluding on any long term consequences. Langli (2015) emphasize on the uncertainty related to the results as the Norwegian audit market is moving from one equilibrium to the next. We will be able to analyse data from five years post amendment, thus the market might have moved closer to the new equilibrium.

3. Research question

We hypothesise that potential effects of the audit exemption on accounting quality will be easier to identify by differentiating by accounting competence. Norwegian companies are required to report whether or not they use an external accountant. While external accountants must be licensed, which implies a high degree of competence, internal accounting does not have the same requirement. The small size of companies exempt from auditing might imply that resources available for accounting are limited, hence use of external accounting should

indicate a higher degree of accounting competence. It would be interesting to examine whether this variable reveals insight on earnings quality and the quality of tax returns. In our literature review we found limited research on external accountant's effect on the accounting quality. Based on this review we have formulated the following research question:

“Which effect does use of an external accountant have on accounting quality in small companies?”

4 Limitations

In our preliminary research question, we have imposed some limitations. We are mainly interested in smaller companies, which are assumed to dedicate less resources to accounting quality than large companies. Companies with sizes near the audit threshold are of special interest, because we can use the thresholds to isolate the effect of external accountants from potential audit effects. We also limit our sample to limited liability companies (Aksjeselskap, AS), as these are more comparable to international company forms. The limited liability also makes it easier to prevent interference of the owner's personal economy. AS is the most preferred Norwegian company form with limited liability, especially after reductions in share capital requirements in 2012.

5 Hypotheses

We can use results from previous research to give us an indication of the results we expect to find. However, the research is conducted on a different sample, time frames, and business areas is not directly transferable. The literature reviewed about earnings management gives us a framework for testing our research question. On the basis of previous research, we have identified the following hypotheses that can help us explore our research question.

H1: Use of an external accountant has a positive effect on the accounting quality.

H2: Use of an external accountant has a positive effect on the quality of the tax returns.

H3: Size management are more common in companies without an external accountant.

6. Data collection and methodology

Financial statements from ASs are publicly available through the Norwegian public register, Brønnøysundregistrene, and a number of third-parties provide interfaces for extraction.

A critical part of our research question depends on measuring accounting quality. The aforementioned data can be used for a general earnings management approach, but the results can be limited by the small size of accruals in our sample's companies. To mitigate this, we have applied for data from the NTA which can be used to develop an alternative measure of accounting quality. This includes tax returns and results from NTA's automated controls of tax reporting quality. The control results indicate both formal and material quality in submitted tax returns and VAT-statements.

We will measure earnings quality by estimating the abnormal discretionary accruals in the dataset by using multiple regression. The model will be inspired by Jones (1991) and subsequent research which adds elements to this model.

7. Plan for thesis progression

January:

Finalize the preliminary thesis report and submit by 15th of January.

Continue to review relevant literature to obtain more indebt knowledge about the field of the research question.

February:

Start the data collection of publicly available data. Identify variables of interest and explore the dataset. Review relevant literature related to methodology and statistics.

March/April:

Data analysis and development of first draft.

May:

Submit first draft to supervisor by May 1st.

Develop second draft.

June:

Finalize the thesis.

June 15:

Internal deadline for completion of Master thesis.

September 1:

Formal deadline for submission.

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