

## Impact of New UK Corporate Governance Code on Earnings Quality- Evidences from UK FTSE 350 Companies

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### Abstract

To reduce the risk of deterioration of earnings quality and the malfunction of the external auditor role, the 2012 edition of the UK Corporate Governance Code bring profound restructuring of the external auditor functions (audit rotation, audit qualification). This paper examines the impact of audit rotation on earnings quality. Earnings quality is measured by the investors' ability to predict future earnings for public and private firms. We use a sample of around 4,117 firm-year observations in the U.K. market for the period 2004-2013. We document evidence that investors are able to better anticipate future earnings when the company regularly changes the auditor. However, the findings are not applicable for private firms.

**Keywords:** Earnings quality; Auditor rotation; Returns-earnings association; Audit quality; Earnings response coefficient; Corporate governance; Earnings predictability

### Introduction

During the last years, the concept of accounting quality has been discussed widely. Earnings quality, which is a part of accounting quality, refers to how well the reported earnings represent real (economic) company performance. But there is still no agreement about its definition and measurement, making it an elusive concept [1]. Earnings are viewed of higher quality, if they accurately characterize the amount by which shareholder value has increased or decreased during the period. Several factors can influence earnings quality of UK FTSE 350 companies. Among these factors, we find external audit.

The external audit committee is a guarantor of the quality of accounting information. But during the recent years, the accounting scandals have multiplied (Enron, Worldcom, Xerox) several factors have contributed to these scandals. Among these factors we find the quality of audit.

To reduce the risk of deterioration of the quality of the earnings of the malfunction of the role of the external auditor, the 2012 edition of the UK Corporate Governance Code bring profound restructuring of the external auditor functions. The restructuring made includes a provision stating that FTSE 350 companies should put the external audit contract out to tender at least every ten years. As with all provisions of the Code, this is on a "comply or explain" basis.

On 15 October 2013, the Competition Commission published its final report closing the chapter on its inquiry into the statutory audit market for FTSE 350 companies. The Commission intends to issue an order to the effect that FTSE 350 companies must put their statutory audit engagement out to tender not less frequently than every ten years.

On 17 January, the Competition Commission announced that it was revising its administrative timetable to enable the Commission to consider the implications of the EU proposals. The Commission is keen to ensure that their Orders do not contradict or duplicate EU regulation.

It is anticipated that there will a further round of consultation on the revised Orders, including the related transitional arrangements, in Q3 2014 and a commencement date in Q4 2014. Preliminary agreement now reached on new European Union audit legislation.

A preliminary agreement on new European Union audit legislation was reached by the European Parliament, the Council of the European Union and the European Commission in December 2013. A summary of key points in the preliminary agreement, which remains subject to a vote in the plenary European Parliament, is provided below based on our current understanding.

As the legal and language review is ongoing and a vote in the European Parliament and approval by the Council remain, the text may undergo changes and interpretation of the text may evolve. In addition to new rules on audit firm rotation, the legislation will also introduce certain restrictions around the provision of non-audit services, a 70% non-audit services fee cap, together with proposals to enhance communications between audit committees and auditors.

In order to study the effect of audit rotation on earnings quality, we try to explain this relation and their future effects. Firstly we start with a literature revue. We divide this title into two parts: literature related to earnings quality and audit rotation. Secondly we present the methodology adopted in this research. We finish by giving the results of the study and a short discussion of the results obtained.

### Literature Review and Research Hypotheses

#### Literature related to earning quality

The concept of earnings quality is fundamental in accounting and financial economics. Yet, there are deep disagreements about how to define and measure it. The list of candidate measures is long: earnings persistence, predictability, asymmetric loss recognition, various forms of benchmark beating, smooth earnings, magnitude of accruals, income-increasing accruals, absolute value of discretionary or abnormal accruals, and the extent to which accruals map into cash

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flows. Complicating the measurement of earnings quality, archival research cannot satisfactorily parse out the portion of managed earnings from the portion resulting from the fundamental earnings process [2].

Earnings predictability is one of the “best” proxy of earning quality. Financial statements are designed to provide value-relevant information for investors (and other users). Investors are using accounting information to study the current performance of a particular firm of interest and then to predict its future prospects. Therefore, high earning quality should enable investors and financial analysts to better anticipate a firm’s future performance and solvency.

A number of definitions of ‘earning quality’ are given in the literature. For example, Diamond and Verrecchia [3] define earning quality as the accuracy of investors’ beliefs about stock prices following the disclosure. King [4] defines disclosure quality as the degree of self-interested bias in corporate disclosure. Hopkins [5] defines disclosure quality as the extent to which current and potential investors can read and interpret the information easily.

Measuring investors’ perception of the firm’s earning quality is not an easy task. Healy and Palepu [6] review academic papers that consider different proxies for the quality of corporate disclosures. They categorise these proxies into three groups: management forecasts, subjective ratings and self-constructed indices. Other studies use computer software packages to automate the generation of the disclosure scores for a large sample of firms [7].

Furthermore, considerable attention has been given to examining the association between disclosure quality and the stock market’s ability to anticipate future earnings. These papers find that the stock market’s ability to anticipate future annual earnings changes is significantly improved when the firm provides higher levels of disclosure. However, these studies did not take into account audit rotation as a potential variable signalling value relevant information for investors when valuing firms’ future prospects.

### Literature related to auditing rotation and hypothesis

**Arguments against auditors rotation:** Firstly Popescu [8] argue that the market reaction is significantly more negative for firms with long auditor tenure compared to firms with shorter auditor tenure. Regarding market reaction, Nicolăescu [9], document that companies receiving a high quality audit from their current auditors experienced a more negative market reaction compared to companies receiving a lower quality audit. This means that investors respond negatively to the discussion of mandatory rotation as they value the expertise of their current auditor.

Investors have an hostile behavior against rotation especially for companies utilizing an industry expert or Big 4 auditor [10]. An explanation of this reaction that investors are more opposed to forced rotation if firms which receiving high quality audits from their current auditor.

Mandatory audit firm rotation may provide benefits to firms and investors by potentially improving audit quality. As size increases, firms might react more positively to the prospect of forced rotation .

Nicolăescu [9] argue that the length of the auditor–client relationship does not significantly affect the opinion of the audit report (long audit tenures do not seem to compromise independence).

Furthermore, establishing a mandatory rotation rule for the audit

firm would not contribute to enhance independence, while increasing costs for the audit sector [11].

Carcello and Rei [10] document that, even a statutory long-term rotation cycle cannot prevent essential agency conflicts. Audit market concentration is an important disadvantage of compulsory rotation.

The Big Four companies have the highest experience value in auditing capital market oriented enterprises. The impacts under external rotation are stronger than for internal auditor rotation.

The majority of empirical assessments disapprove of audit firm rotation. An enhancement of auditor independence will not necessarily be achieved by implementing external rotation [12].

**Arguments in favor of auditor’s rotation:** The external auditor’s role is crucial in the corporate governance scheme [13]. Long auditor-client relationships may cause auditor complacency about management decisions regarding the firm’s financial statements. The mandatory rotation of external auditors may improve independence. In high litigation risk countries, auditors could be less willing to impair independence compared with the situation in low litigation risk countries. The opinion of the audit report depends on the characteristics of the incumbent auditor.

NonBig4 auditors tend to audit relatively small companies, whereas large firms are more able to avoid losses than small firms. Firms with unqualified reports show significantly longer tenures compared with firms with qualified reports.

Auditor rotation rules may provide some benefits in terms of auditor independence, involving an increase in learning costs [14] for the audit sector associated to new clients. External auditor rotation may be a way to enhance audit quality due to prevention of the auditor’s depending relationship with the management [15].

The previous research does not provide the same results related to the perception of auditors rotation by investors. Some researches confirm a positive market response and others confirm a negative reaction. But the common point is that market reacts when company change it auditor (positively or negatively).

### Earnings quality and auditor rotation

**Hypothesis 1: Investors reacts after the announcement of the auditor rotation:** Audit partner rotation is a costly practice for auditing firms. Longer audit firm tenure is associated with higher quality financial reporting. Changes resulting from audit partner rotation are more limited in scope than changes from audit firm rotation.

The rotation has impacted the quality of accounting information [16] disclosed to the market by Brazilian public companies: rotation of the auditing firm does not have a significant effect on the propensity of listed Brazilian companies to manage earnings [17].

Rotation of auditors may be a means of enhancing auditor dependence [18] and building shareholder confidence in the integrity of the firm’s financial statements. There is a greater perception of auditor independence and likelihood that errors discovered by the auditors will be reported when a company follows a rotation policy. Rotating appears to enhance perceptions of auditor independence [19].

Like the studies related to investors reaction after the announcement of auditor rotation, the previous research does not provide a common correlation between earnings quality and auditor rotation. Some researches confirm a positive correlation between earnings quality and

auditor rotation and others confirm a negative correlation. But the common point is that there are correlations between earnings quality and auditor rotation (positively or negatively).

**Hypothesis 2: There are strong correlations between earnings quality and auditor rotation:** Previous evidence in Hopkins [5] finds that financial statement classification influences the stock price judgments of a sophisticated financial statement user group. However, Hayn [20] finds that the strength of the association between annual stock returns and annual reported earnings changes is considerably lower for public firms than for private firms.

Eugen [16] argue that the auditor rotation in private companies is more frequent than in public enterprises. it indicates a reaction of the broader market for the first companies.

Schleicher et al. [7] provide evidence that the association between corporate disclosure and the investor's ability to anticipate future earnings change is not the same for public and private firms. They find that the ability of stock returns to anticipate next year's earnings change is significantly stronger for high disclosure public firms. They do not find the same results for private firms.

Therefore, based on the results in Schleicher et al. [7], it will be safe to examine the sensitivity of the results by examining the impact of auditor rotation on earnings predictability for public and private firms. Thus, the third hypothesis states:

**Hypothesis 3:** The strength of the degree of association between investor's ability to anticipate future earnings and auditor rotation is not the same for public firms and private firms.

## Methodology

### Statistic model

The present paper uses the Collins et al. returns-future earnings regression model to measure earnings predictability and to test the research hypothesis.

However, only two future earnings growth variables are included in the regression (N=2 and k=1, 2) rather than three future years. In addition, in defining the earnings growth variable, earnings change is deflated by price and not by lagged earnings. The latter adjustment is made to preserve a maximum number of observations for the analyses [7]. These adjustments yields the following modified model:

$$R_t = b_0 + b_1 X_t + \sum_{k=1}^2 b_{k+1} X_{t+k} + \sum_{k=1}^2 b_{k+N+1} R_{t+k} + b_{2N+2} EP_{t-1} + b_{2N+3} AG_t + u_t \quad (1)$$

Where

$b_0$  : Intercept

$b_1 - b_8$  : Coefficient of slope parameters;

$\mu$  : Error term.

$R_t$  : Stock return for period  $t$

$X_t$  : Stock return for period  $t+1$  (*date of auditor rotation*)

$X_{t+2}$  : Stock return for period  $t+2$

$X_t$  : Earnings change per share in period  $t$  deflated by the share price four months after the end of the financial year  $t-1$

$X_{t+1}$  : Earnings change per share in period  $t+1$  deflated by the share price four months after the end of the financial year  $t-1$

$X_{t+2}$  : Earnings change per share in period  $t+2$  deflated by the share price four months after the end of the financial year  $t-1$

$EP_{t-1}$  : Earnings yield is defined as earnings per share for period  $t-1$  divided by share price four months after the end of the financial year  $t-1$

$AG_t$  : Total assets growth for period  $t$

Further, the above model is expanded by including an audit dummy variable ( $RAUDIT$ ) to examine the potential value of audit rotation to investors. All right-hand side variables are interacted with this dummy (1=when firm change auditor; 0 otherwise). All explanatory variables in (1) are interacted with the dummy variable,  $RAUDIT$ . This yields the following regression model that is used to test the research hypotheses:

$$R_t = b_0 + b_1 X_t + \sum_{k=1}^2 b_{k+1} X_{t+k} + \sum_{k=1}^2 b_{k+3} R_{t+k} + b_4 EP_{t-1} + b_5 AG_t + b_6 RAUDIT + b_7 [RAUDIT * X_t] + \sum_{k=1}^2 b_{k+9} [RAUDIT * X_{t+k}] + \sum_{k=1}^2 b_{k+11} [RAUDIT * R_{t+k}] + b_{14} [RAUDIT * EP_{t-1}] + b_{15} [RAUDIT * AG_t] + u_t \quad (2)$$

### Data

Schleicher et al. [7] examine the association between voluntary disclosure and investors' ability to predict future earnings in UK market. Their sample size was  $Rt+1$   $Rt+2$  4568 firms-years for the period 2004-2013 (financial institutions are excluded). The present study uses the same sample collected by Schleicher et al. [7] to examine the effect of auditor rotation on share price anticipation of earnings. However, the number of firms is reduced further due to missing information about audit rotation. The number of usable observations used in the present study is 4117 firm-years for the period 2004-2013. This presents a sample of 3666 private firms and 451 public firms. Table 1 provides descriptive statistics on the independent variable and control variables used in examining the association between earnings quality and audit rotation (Table 1).

Datastream is used to collect accounting and return data. Earnings number is defined as operating income before all exceptional items (Worldscope item 01250). Earnings per share is obtained by dividing item 01250 by the outstanding number of shares. Stock returns are calculated as buy-and-hold returns (inclusive of dividends) over a 12-month period from eight months before the financial year-end to four months after the financial year-end. Earnings yield,  $EP_{t-1}$ , is defined as period  $t-1$ 's earnings over price four months after the financial year-end of period  $t-1$ .  $AG_t$  is the growth rate of book value of total assets (Worldscope item 02999) for period  $t$  (Table 2).

### Results

The effect of audit rotation on the investors' ability to predict future earnings is examined on Table 2. For the whole sample, a result shows that the coefficient on  $X_t$  is positive and significant at the 1% level. Additionally, there is evidence that investors are able to anticipate

	Mean	Std	Max	Min
Stock Return (R)	2,654	0,675	4,765	-0,987
Earnings Change	0,548	0,356	1,876	-2,098
Total Assets	0,084	0,029	0,104	-0,073
Growth (AG)				
RAUDIT	0,453	0,098	1	0
Full Observations			4117	
Public Firms			3666	
Private Firms				

Table 1: Descriptive Statistics.

Variable	Coeff.
	[P-Value]
Intercept	-0.041 ***
	[0.001]
$R_{t+1}$	0.649***
	[0.001]
$R_{t+2}$	0.232***
	[0.001]
$X_t$	0.567***
	[0.001]
$X_{t+1}$	0.604***
	[0.001]
$X_{t+2}$	0.232***
	[0.001]
$EP_{t-1}$	0.09***
	[0.001]
$AG_t$	0.785***
	[0.001]
RAudit	0.00
	[0.999]
$R_{t+1}$	0.008
	[0.439]
$R_{t+2}$	0.001
	[0.605]
$X_t$	1.384***
	[0.001]
$X_{t+1}$	0.602***
RAudit*	[0.001]
$X_{t+2}$	0.475***
	[0.001]
$EP_{t-1}$	0.823***
	[0.001]
$AG_t$	-0.069***
	[0.001]
Adj. R <sup>2</sup>	0.324

The significance levels (two-tail test): \*=10 percent, \*\*=5 percent, \*\*\*=1 percent. P-values are reported in parentheses.

**Table 2:** The effect of auditor rotation on investors' ability to predict future earnings.

future earnings two years ahead for firms which change its auditor.

The estimate coefficients on  $X_{t+1}$  and  $X_{t+2}$  are positive and significant at the 1 Percent level. The incremental predictive value of auditor rotation for earnings predictability by investors is given by the estimate coefficients on  $RAudit * X_{t+1}$  and  $RAudit * X_{t+2}$ . These coefficients are positive and highly significant at the 1% level. These results indicate that current stock returns incorporate future earnings information much more strongly for companies which rotate its auditor than companies which retained the same auditor. Therefore, hypothesis 1 and 2 are supported (not rejected) based on the sample results.

To test hypotheses 3; the sample is divided into two categories: public and private firms. A regression model is then run for each category. Table 3 shows the effect of auditor rotation on investors' ability to predict future earnings through distinction between public firms and private firms (Table 3). As shown in Table 3, a result shows a number of significant differences between public and private firms.

## Discussion

**Firstly:** A Higher earnings response coefficient on the current earnings variable for public firms than private firms. The coefficient

on  $X_t$  is 0.75 with a p-value of 0.001 for public firms, while it is insignificantly negative for private firms ( $X_t = -0.11$  with a p-value of 0.559). These results are consistent with Daniels and Booker and Nicolaescu [18] who find that the auditor rotation enhances auditor independence and confidence. This result is expected because usually public companies are required by British law to change auditor each 6 years.

**Secondly:** There is no evidence of share price anticipation of earnings for public firms which rotate its auditor. For these companies, the coefficient estimate on  $X_{t+1}$  is 0.03 with a p-value of 0.883 and the coefficient estimate on  $X_{t+2}$  is -0.11 with a p-value of 0.401. These results indicate that investors are not able to predict future earnings for private firms which retain the same auditor. In contrast there is strong evidence that public companies which save the same auditor do exhibit share price anticipation of earnings for two years ahead. The coefficients estimates on  $X_{t+1}$  and  $X_{t+2}$  are positive (0.84 and 0.17, respectively) and significant at the one percent level (p-values=0.001 and 0.001, respectively).

**Thirdly:** for the effect of auditor rotation on the investors' ability to predict future earnings, we find that the coefficient estimates on  $RAudit * X_{t+1}$  and  $Audit * X_{t+2}$  for private firms are still insignificant ( $RAudit * X_{t+1} = -0.03$  with a p-value of 0.877 and  $RAudit * X_{t+2} = 0.16$  with

Variable	Coeff.	
	Public firms	Private firms
Intercept	-0.03*	-0.28***
	[0.094]	(0.001)
$R_{t+1}$	-0.04*	-0.03
	[0.082]	[0.113]
$R_{t+2}$	-0.03	-0.03
	[0.249]	[0.179]
$X_t$	0.75***	-0.11
	[0.001]	[0.559]
$X_{t+1}$	0.84***	0.03
	[0.001]	[0.883]
$X_{t+2}$	0.17***	-0.11
	[0.001]	[0.401]
$EP_{t-1}$	0.13***	0.09***
	[0.001]	[0.001]
$AG_t$	0.52***	-0.12
	[0.001]	[0.546]
RAudit	-0.07***	0.07
	[0.001]	[0.165]
	[0.770]	[0.419]
$R_{t+2}$	-0.04*	-0.01
	[0.090]	[0.955]
$X_t$	1.72***	0.23
$R_{t+1}$	0.01	0.02
$X_{t+1}$	0.57***	-0.03
udit*	[0.001]	[0.877]
$X_{t+2}$	0.21***	0.16
	[0.001]	[0.306]
$EP_{t-1}$	0.87***	0.12
	[0.001]	[0.559]
$AG_t$	-0.12	-0.10***
	[0.001]	[0.001]
Adj. R <sup>2</sup>	0.113	0.022

**Table 3:** Auditor Rotation and Prediction of Earnings Prediction for public and Private Firms.

a p-value of 0.306). These results indicate that auditor rotation does not improve the stock market's ability to predict future earnings for private firms. In contrast there is a significant effect of auditor rotation on investors' earnings predictability for public firms. The coefficient estimates on  $RAudit' X_{t+1}$  and  $RAudit' X_{t+2}$  for public firms are positive and significant at the one percent level ( $RAudit' X_{t+1}=0.57$  with a p-value of 0.001 and  $RAudit' X_{t+2}=0.21$  with a p-value of 0.001).

Overall the evidence for public firms suggests that investors are able to anticipate future earnings changes two years ahead, and this ability is improved when the firm if the company involves a new auditor. On the other hand, the same results were not found for private firms when it removes the first auditor.

A statistical test to examine the extent to which the association between investors' ability to predict future earnings and auditor rotation is significantly stronger for public firms than private firms was done. This test was done by including all firms in one dataset and creating a dummy variable to be equal 1 for public firms and zero otherwise and interacting the profit dummy variable throughout the model.

This analysis shows that the coefficient estimate on  $profit' RAudit' X_{t+1}$  and  $profit' RAudit' X_{t+2}$  are positive and significant at the 1 % level (not reported in the table). This suggests that the strength of the degree of association between investors' ability to anticipate future earnings and auditor rotation is not the same for public firms and private firms. Therefore, hypothesis 2 is supported (not rejected) based on the sample results.

## Conclusion

The Future Earnings Response Coefficient "FERC" framework previously used by Hussainey et al. [7] and others was used to investigate whether auditor rotation is positively associated with earnings predictability (the investors' ability to anticipate future earnings). The findings are based on a sample of 4117 companies for the year ends during 2004 to 2013.

Evidence is found that financial statements reveal value relevant information to investors for predicting future earnings. Investors' earnings predictability is increased when companies rotate their auditor. However, these findings are not applicable for private firms.

The research findings may have important implications for auditor rotation literature. The findings show that auditor rotation is a good proxy for the actual and perceived audit quality. Therefore, firms need to pay attention to who audit their financial statements because this type of information is important to their key stakeholders (i.e. investors and financial analysts) in making their investment decisions.

Similar to Popescu [8] the present study tries to answer a particular research question: Auditor rotation enhance earnings quality (measured by earnings predictability)? Therefore it ignores some variables of interest that would affect the investors' earnings predictability. In particular, the present study includes a number of limitations. First, it ignores the importance of voluntary disclosure as a value-relevant source of information to investors. Second, it ignores the fact that companies might use different communication channels to convey value relevant information for investors (these include interim reports, conference calls and presentation to financial analysts). Finally it ignores the effect of dividend propensity as an effective value relevant signal for investors in predicting future earnings.

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