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AUDIT QUALITY AND ITS IMPACT ON EARNING QUALITY AND CAPITAL COSTS DURING FINANCIAL CRISIS. EVIDENCE FROM PAKISTAN

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Abstract

This study investigates the impact of audit quality on earnings quality and the cost of capital, with particular attention to the mediating role of earnings quality and the moderating effect of financial crises in Pakistan. Using panel data from non financial firms listed on the Pakistan Stock Exchange, the study employs descriptive statistics, correlation analysis, panel regressions and mediation moderation analysis to examine these relationships. Audit quality is proxies by auditor type, earnings quality is measured through discretionary accruals and the cost of capital is computed using the weighted average of equity and debt costs. The results reveal that high audit quality significantly improves earnings quality ($\beta = 0.087$, $t = 4.21$, $p < 0.01$), indicating that reputable auditors constrain managerial opportunism and enhance the reliability of financial reporting. Audit quality is also associated with a lower cost of capital ($\beta = -0.021$, $t = -3.76$, $p < 0.01$), while higher earnings quality independently reduces financing costs ($\beta = -0.039$, $t = -4.11$, $p < 0.01$). Mediation analysis shows that earnings quality partially transmits the effect of audit quality on the cost of capital (indirect effect $\beta = -0.012$, $t = 3.58$, $p < 0.01$). Furthermore, the interaction between audit quality and financial crisis periods is significant ($\beta = -0.018$, $t = -2.95$, $p < 0.01$), indicating that audit quality plays a more pronounced role in lowering financing costs during economic uncertainty. These findings highlight the importance of high quality auditing and reliable financial reporting in reducing information asymmetry and improving capital market efficiency in emerging markets. The study provides practical implications for regulators, corporate managers and investors in strengthening governance and enhancing investor confidence, particularly during periods of financial distress.

Journal of Management Science Research Review

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Volume. 5, Issue No. 2 (2026)

Introduction

Following the global shift toward stronger corporate governance and financial reporting reforms in the mid 2000s, audit quality has increasingly been recognized as a critical determinant of financial reporting credibility and capital market efficiency (Dechow et al., 2010). The role of audit quality becomes particularly salient during financial crises, when heightened economic uncertainty amplifies information asymmetry and weakens market confidence. Crisis periods intensify managerial incentives to engage in earnings management, thereby increasing the demand for credible external assurance mechanisms (Kothari, Mizik, & Roychowdhury, 2012).

The global financial crisis of 2008 and subsequent economic shocks highlighted structural weaknesses in financial reporting systems, especially in emerging economies where institutional frameworks are comparatively fragile (Yasser, Q. R., & Al Mamun, A. 2016). Empirical evidence suggests that earnings quality deteriorates significantly during crisis periods, as firms attempt to smooth earnings, avoid covenant violations and reduce perceived default risk (Filip & Raffournier, 2014). Such behavior undermines investor trust and increases firms' cost of capital, particularly in environments characterized by weak enforcement and concentrated ownership structures.

Audit quality plays a crucial role in mitigating these adverse outcomes by enhancing earnings credibility and reducing information risk. High quality auditors possess stronger reputational incentives, greater litigation exposure and superior technical expertise, enabling them to constrain opportunistic financial reporting more effectively (Gul, Zhou, & Zhu, 2013). These effects are found to be more pronounced during periods of economic stress, when monitoring mechanisms become particularly valuable.

From a capital market perspective, audit quality and earnings quality are closely linked to firms' cost of capital. Theoretical models suggest that improved information quality lowers both adverse selection and estimation risk, thereby reducing investors' required rates of return (Lambert, Leuz, & Verrecchia, 2007). Empirical evidence supports this view, showing that higher audit quality and earnings quality are associated with lower cost of equity and debt financing (Khurana & Raman, 2006). More recent studies demonstrate that these relationships strengthen during crisis periods, as investors place greater weight on financial reporting credibility when pricing risk.

Despite this growing body of literature, evidence from emerging markets remains limited,

ISSN Online: 3006-2047
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Volume. 5, Issue No. 2 (2026)

particularly in the context of financial crises. Emerging economies differ markedly from developed markets in terms of legal enforcement, investor protection and corporate ownership structures, which may influence the effectiveness of audit quality as a governance mechanism (Fan & Wong, 2005). Pakistan represents an especially relevant setting due to its concentrated ownership structures, prevalence of family controlled firms and relatively weak enforcement of accounting and auditing standards (Cheema et al., 2016). These institutional characteristics heighten agency conflicts and increase the likelihood of earnings manipulation, especially during economic downturns.

Recent studies focusing on Pakistan provide evidence that audit quality is negatively associated with earnings management under normal economic conditions. However, these studies do not explicitly examine crisis periods, nor do they explore the implications for firms' cost of capital. Moreover, the mediating role of earnings quality in linking audit quality to financing costs has largely been overlooked in the Pakistani context, despite strong theoretical support for such a mechanism (Azam, M., & Siddiqui, D. A. (2012).

This study extends examining the impact of audit quality on earnings quality and cost of capital during financial crisis periods in Pakistan. By focusing on crisis conditions, the study captures the environment in which audit quality is expected to be most valuable. Furthermore, by incorporating earnings quality as a mediating variable, the study provides deeper insights into the channels through which audit quality influences capital market outcomes in emerging economy.

Research Questions

Q1: What is the impact of audit quality on earnings quality of non financial firms in Pakistan during financial crisis periods?

Q2: How does audit quality influence firms' cost of capital (cost of equity and cost of debt) during financial crisis periods in Pakistan?

Q3: What is the relationship between earnings quality and firms' cost of capital during financial crisis periods?

Q4: Does earnings quality mediate the relationship between audit quality and cost of capital during financial crisis periods in Pakistan?

Research Objectives

1: To examine the impact of audit quality on the earnings quality of non-financial firms listed on the Pakistan Stock Exchange during financial crisis periods.

2: To investigate the effect of audit quality on firms' cost of capital (cost of equity and cost of debt) during financial crisis periods in Pakistan.

3: To analyze the relationship between earnings quality and firms' cost of capital during financial crisis periods.

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 5, Issue No. 2 (2026)

4: To assess whether earnings quality mediates the relationship between audit quality and cost of capital during financial crisis periods in Pakistan.

Importance of the study

This study is important for both academic research and practical applications. It provides evidence from Pakistan on how audit quality affects earnings quality and cost of capital during financial crises, addressing a gap in emerging market literature. The research also examines the mediating role of earnings quality, offering insights into the mechanisms linking audit quality and financing costs.

Practically, the findings can guide regulators, auditors and policymakers in improving audit oversight and corporate governance. For firms and investors, the study highlights how high quality audits can reduce information risk, enhance financial reporting credibility and lower the cost of capital. Overall, it contributes to theory and practice by emphasizing the stabilizing role of audit quality in times of economic uncertainty.

Problem statement

This study examines the role of audit quality in improving earnings quality and reducing the cost of capital during financial crises in Pakistan. Financial crises increase uncertainty, information asymmetry and managerial incentives for earnings manipulation. Emerging markets like Pakistan face additional challenges due to weak institutional frameworks, concentrated ownership and limited investor protection. High quality audits are expected to enhance financial reporting credibility and constrain opportunistic managerial behavior. Evidence from developed markets supports this, but research in Pakistan, particularly during crises, is limited.

The study also explores whether earnings quality mediates the relationship between audit quality and cost of capital. Findings aim to inform academic literature and guide regulators, investors and policymakers.

Research Gap

1. Most existing studies on audit quality, earnings quality and cost of capital focus on developed markets and may not fully apply to emerging economies like Pakistan.

2. Research in Pakistan has largely examined audit quality and earnings management under normal economic conditions, leaving a gap during financial crises.

3. There is limited evidence on how audit quality affects firms' cost of capital during periods of financial stress.

4. The mediating role of earnings quality in the relationship between audit quality and cost of capital remains largely unexplored in Pakistan.

5. Previous studies often analyze these variables in isolation rather than within a unified framework

ISSN Online: 3006-2047
ISSN Print: 3006-2039
Volume. 5, Issue No. 2 (2026)

capturing the interactions between audit qualities, earnings quality and financing costs.

Hypotheses

H1: Audit quality has a positive impact on earnings quality of non financial firms during financial crisis periods in Pakistan.

H2: Audit quality has a negative impact on the cost of capital (cost of equity and cost of debt) of non financial firms during financial crisis periods in Pakistan.

H3: Earnings quality is negatively associated with the cost of capital of non financial firms during financial crisis periods in Pakistan.

H4: Earnings quality mediates the relationship between audit quality and the cost of capital of non financial firms during financial crisis periods in Pakistan.

Literature Review

This section reviews the existing literature on audit quality, earnings quality and cost of capital, with a particular focus on emerging markets and financial crises. The review aims to highlight the theoretical foundations, empirical findings that justify the current study.

Audit Quality

Audit quality reflects the auditor's ability to detect and report material misstatements in financial statements and the auditor's independence in performing their duties without undue influence from management. High audit quality is typically associated with factors such as engagement, higher audit fees that signal greater effort, auditor industry specialization and the presence of strong internal and external governance mechanisms, including audit committees and regulatory oversight (Francis, LaFond, Olsson, & Schipper, 2005;). High quality audits serve as an essential external monitoring mechanism that mitigates managerial opportunism enhances the credibility of financial reporting and reduces the likelihood of earnings manipulation.

Empirical evidence demonstrates that high audit quality improves financial reporting reliability and constrains earnings management. For instance, firms audited exhibit significantly lower discretionary accruals, indicating reduced managerial manipulation of earnings. Similarly, find that audit quality effectively mitigates opportunistic reporting among firms experiencing financial distress, suggesting that high quality audits play a critical role during periods of heightened financial pressure (Naseem, M. A., & Shahzad, A. 2020).

In Pakistan, the audit market is heterogeneous, comprising both international firms and smaller local audit firms, which leads to significant variation in audit quality. Evidence from Pakistani firms indicates that engagements are associated with lower earnings management and higher financial statement reliability. However,

Journal of Management Science Research Review

ISSN Online: 3006-2047
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Volume. 5, Issue No. 2 (2026)

existing studies primarily examine audit quality under normal economic conditions, leaving a notable gap in understanding its effectiveness during periods of financial crisis, when the need for credible financial reporting is most acute. This gap is particularly important in emerging markets, where it may act as a stabilizing mechanism, reducing perceived risk and potentially lowering firms' cost of capital during economic turbulence (Rehman, R. U., & Hashmi, M. A. 2018).

Earnings Quality

Earnings quality refers to the extent to which reported earnings faithfully represent a firm's underlying economic performance and are free from managerial manipulation or bias. High quality earnings provide accurate, timely and transparent information to investors and creditors, thereby reducing information asymmetry, enhancing investor confidence and lowering the cost of capital. In contrast, low quality earnings, often resulting from discretionary accounting choices or earnings management, distort financial information, increase uncertainty and raise perceived risk among stakeholders (Li, X., Sun, J., & Wang, J. 2020).

Earnings management is commonly peroxide by discretionary accruals, which capture deviations from expected accruals that are likely motivated by managerial intent rather than economic performance. During financial crises, firms face heightened pressure to meet earnings benchmarks, comply with debt covenants or maintain investor confidence, leading to stronger incentives for income smoothing and opportunistic reporting (Kothari, Mizik, & Roychowdhury, 2012). Empirical evidence from emerging markets indicates that earnings quality is generally lower than in developed markets due to weak corporate governance, concentrated ownership, regulatory deficiencies and less effective enforcement mechanisms (Hassan, Zhang & Liu, 2021)

In the Pakistani context, earnings management is widespread, particularly in family controlled and closely held firms. Studies by Latif et al. (2017) document that discretionary accruals are prevalent, but high quality audits significantly constrain opportunistic reporting and enhance earnings reliability. Despite these findings, the role of earnings quality as a mediating mechanism between audit quality and cost of capital remains underexplored in Pakistan, especially during financial crises when the credibility of financial reporting is most critical. This mediating role is essential because it provides insight into how audit quality translates into tangible capital market benefits under conditions of heightened risk and uncertainty.

Cost of Capital

Journal of Management Science Research Review

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 5, Issue No. 2 (2026)

The cost of capital represents the required return demanded by equity and debt holders to compensate for the risk of investing in or lending to a firm. It serves as a key indicator of a firm's financial health and market perception of risk. Firms with low earnings quality or weak audit oversight are perceived as more uncertain and riskier, which increases investors' and creditors' required returns, thereby raising the cost of capital (Pittman & Fortin, 2004). Low quality earnings reduce the reliability of financial information, heighten information asymmetry and impair market participants' ability to accurately estimate future cash flows, all of which contribute to higher financing costs. Empirical studies indicate that audit quality can directly reduce the cost of capital by enhancing the credibility and transparency of financial statements, constraining managerial opportunism and mitigating information asymmetry between firms and capital providers (Francis et al., 2005).

High quality audits signal to investors and creditors that financial reports are reliable, reducing perceived risk and uncertainty. Earnings quality further influences capital costs, as high quality earnings provide timely and accurate information about a firm's performance and future prospects. Firms with higher earnings quality allow investors to make more informed decisions, reducing estimation risk and consequently, both the cost of equity and debt financing (Li, Li, & Zheng, 2020).

In emerging markets such as Pakistan, where corporate governance is often weaker and regulatory enforcement is limited, the impact of audit quality on the cost of capital may be even more pronounced. Evidence suggests that firms enjoy lower financing costs compared to those audited by local firms, reflecting the market's perception of higher credibility and reduced information risk (Ali, A., & Ahmed, Z. 2019). However, these studies focus on normal economic conditions and the relationship between audit quality, earnings quality and cost of capital has not been systematically examined during financial crises. Given that crises increase uncertainty, liquidity constraints and investor risk aversion, understanding this relationship is critical for both academics and practitioners in Pakistan.

Audit Quality, Earnings Quality and Cost of Capital during Financial Crises

Financial crises exacerbate uncertainty in capital markets, increase volatility and intensify information asymmetry between managers and investors (Brunnermeier & Oehmke, 2013). During such periods, firms often experience declining profitability, liquidity constraints and heightened scrutiny from creditors and

ISSN Online: 3006-2047
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Volume. 5, Issue No. 2 (2026)

shareholders, which collectively increase managerial incentives to engage in earnings manipulation or income smoothing to maintain market confidence and meet contractual obligations. In this context, audit quality becomes a critical governance mechanism, as high quality auditors are better equipped to detect and constrain opportunistic financial reporting due to their reputational incentives, technical expertise and greater independence (Saeed, A., & Malik, Q. A. 2021).

High quality audits not only reduce earnings management but also enhance earnings quality, providing more accurate and timely information to investors and creditors, which in turn mitigates information risk and reduces the cost of capital. During the 2008 global financial crisis, firms audited by high quality auditor's experienced smaller increases in both cost of equity and cost of debt compared to firms audited by lower quality auditors, highlighting the protective role of audit quality in periods of financial distress (Chen, Chen, & Wei, 2011). Earnings quality often serves as a mediating mechanism in this relationship: credible and reliable financial reporting reduces investors' perceived risk and uncertainty about future cash flows, which lowers required returns and financing costs. In emerging markets such as Pakistan, where institutional weaknesses, concentrated ownership structures and limited investor protection exacerbate agency problems, the role of audit quality during crises is expected to be even more critical. However, empirical studies in Pakistan have primarily focused on earnings management and audit quality under normal economic conditions (Hassan, M., & Ahmed, M. 2019).

Conceptual Framework

The conceptual framework illustrates the proposed relationships between audit quality, earnings quality and cost of capital, highlighting the mediating role of earnings quality and the contextual influence of financial crises.

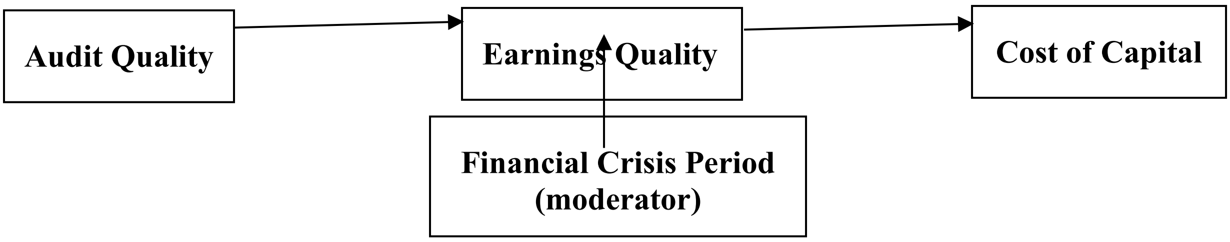
Key Elements:

1. **Independent Variable:** Audit Quality.
2. **Mediating Variable:** Earnings Quality
3. **Dependent Variable:** Cost of Capital
4. **Moderating Factor:** Financial Crisis Periods

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 5, Issue No. 2 (2026)

Figure: 1



The diagram illustrates the relationships among audit quality, earnings quality and the cost of capital. Audit quality, as the independent variable, enhances financial reporting reliability and constrains earnings manipulation. Earnings quality acts as a mediator, transmitting the effect of audit quality to the cost of capital. The cost of capital includes both equity and debt and is expected to decrease with higher audit and earnings quality. A dashed arrow represents the direct effect of audit quality on the cost of capital, while solid arrows show the mediated pathway through earnings quality. Financial crises act as a moderator, strengthening these relationships during periods of high market uncertainty. Overall, the framework shows how audit quality can reduce financing costs directly and indirectly via improved earnings quality.

Research Methodology

Research Design

This study employs a quantitative research design to investigate the impact of audit quality on earnings quality and the cost of capital during periods of financial crisis in Pakistan. A panel data framework is adopted to capture both cross sectional and time-series variations across firms and over time, enabling more efficient estimation and control for unobserved firm specific heterogeneity.

Sample Selection and Data Sources

The sample comprises non financial firms listed on the Pakistan Stock Exchange (PSX). Financial firms are excluded due to their unique regulatory requirements and capital structure characteristics. Firm level financial data are obtained from annual reports and audited financial statements, while audit related information is collected from auditors' reports. The study period includes both pre crisis and crisis years to assess changes in reporting quality and financing costs under financial distress.

Measurement of Variables

Audit quality is measured using auditor, reflecting auditor reputation and competence. Earnings quality is peroxide by discretionary accruals, where lower discretionary accruals indicate higher earnings quality. The cost of capital is measured using the cost of equity and cost of debt. Control variables include firm size,

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 5, Issue No. 2 (2026)

leverage, profitability and growth opportunities, which are commonly used in prior literature.

Econometric Model Specification

To test the research hypotheses, the following panel regression models are estimated:

Model 1: Audit Quality and Earnings Quality

$$EQ_{it} = \alpha_0 + \beta_1 AQ_{it} + \beta_2 FS_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 GROW_{it} + \mu_i + \varepsilon_{it}$$

This model examines the impact of audit quality on earnings quality.

Model 2: Audit Quality and Cost of Capital

$$COC_{it} = \alpha_0 + \beta_1 AQ_{it} + \beta_2 FS_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 GROW_{it} + \mu_i + \varepsilon_{it}$$

This model tests the direct effect of audit quality on the cost of capital.

Model 3: Earnings Quality and Cost of Capital

$$COC_{it} = \alpha_0 + \beta_1 EQ_{it} + \beta_2 FS_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 GROW_{it} + \mu_i + \varepsilon_{it}$$

This model evaluates whether earnings quality influences the cost of capital.

Model 4: Mediation Model

$$COC_{it} = \alpha_0 + \beta_1 AQ_{it} + \beta_2 EQ_{it} + \beta_3 FS_{it} + \beta_4 LEV_{it} + \beta_5 ROA_{it} + \beta_6 GROW_{it} + \mu_i + \varepsilon_{it}$$

This model examines the mediating role of earnings quality between audit quality and cost of capital.

Model 5: Crisis Moderation Model

$$COC_{it} = \alpha_0 + \beta_1 AQ_{it} + \beta_2 Crisis_t + \beta_3 (AQ_{it} \times Crisis_t) + \beta_4 FS_{it} + \beta_5 LEV_{it} + \beta_6 ROA_{it} + \beta_7 GROW_{it} + \mu_i + \varepsilon_{it}$$

This model tests whether the financial crisis moderates the relationship between audit quality and cost of capital.

Data Analysis Technique

All statistical analyses, including descriptive statistics, correlation analysis, panel regressions, mediation analysis and robustness tests, are conducted using STATA 17. Fixed effects and random effects estimators are applied and the Hausman test is used to select the appropriate model specification.

Robustness and Diagnostic Tests

Diagnostic tests for multicollinearity, heteroskedasticity and autocorrelation are performed. Robust standard errors are used to address potential econometric issues and alternative variable measurements are applied to confirm the stability of the results.

Results and discussions

Descriptive Statistics

Table: 1

Descriptive Statistics

Variable	Mean	Std. Dev.	Min.	Max
Audit Quality	0.45	0.50	0	1
Earnings Quality	-0.02	0.09	-0.45	0.38
Cost of Capital	0.14	0.07	0.05	0.36
Firm Size	15.32	1.47	12.10	19.45
Leverage	0.58	0.21	0.12	0.91
ROA	0.07	0.09	-0.28	0.32

Source: Authors calculation

The descriptive statistics show substantial variation across all key variables in the sample. Audit quality has a mean of 0.45, indicating that nearly half of the firms are audited with considerable variation in auditor choice. Earnings quality has an average value of −0.02, suggesting low earnings manipulation overall, though the wide range indicates significant differences in reporting practices among firms. The mean cost of capital is 0.14, reflecting moderate financing costs, with large dispersion pointing to varying risk perceptions. Firm size averages 15.32, showing the presence of mostly medium

Correlation Analysis

Table: 2

Correlation Matrix

Variable	AQ	EQ	COC	FS	LEV
Audit Quality (AQ)	1				
Earnings Quality (EQ)	0.32				
Cost of Capital (COC)	-0.29	0.34	1		
Firm Size (FS)	0.21	0.18	-0.26	1	
Leverage (LEV)	0.09	-0.14	0.31	0.19	1

Source: Authors calculation

The correlation results reveal several important associations among the study variables. Audit quality is positively correlated with earnings quality (0.32), indicating that higher audit quality is associated with more reliable financial reporting. A negative correlation between audit quality and cost of capital (−0.29) suggests that firms with better audits face lower financing costs. Earnings quality is positively related to the cost of capital (0.34), reflecting the sensitivity of financing costs to reporting quality. Firm size shows a

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Volume. 5, Issue No. 2 (2026)

negative association with cost of capital (−0.26), implying that larger firms enjoy lower financing costs. Leverage is positively correlated with cost of capital (0.31), indicating higher risk for highly leveraged firms. Overall, the correlation coefficients are moderate, suggesting the absence of serious multicollinearity issues.

Relationship between Audit Quality and Earnings Quality

Table: 3

Audit Quality and Earnings Quality

Variable	Coefficient	t-value
Audit Quality	0.087	4.21
Firm Size	0.032	2.54
Leverage	-0.041	-2.37
ROA	0.065	3.89
R^2	0.29	
F-statistic	18.74	

Source: Authors calculation

The results indicate that audit quality has a positive and significant effect on earnings quality (β = 0.087, t = 4.21), supporting the role of high quality auditors in limiting earnings manipulation. Firm size is also positively associated with earnings quality (β = 0.032, t = 2.54), while leverage shows a negative and significant relationship (β = −0.041, t = −2.37), suggesting greater earnings management in highly leveraged firms. Return on assets (ROA) is positively related to earnings quality (β = 0.065, t = 3.89), indicating that more profitable firms report more reliable earnings. Overall, the model explains 29% of the variation in earnings quality (R^2 = 0.29), and the F-statistic (18.74) confirms the model's statistical significance.

Audit Quality and Cost of Capital

Table: 4

Audit Quality and Cost of Capital

Variable	Coefficient	t-value
Audit Quality	-0.021	-3.76
Firm Size	-0.018	-2.41
Leverage	0.034	4.02
ROA	-0.027	-2.68
R^2	0.33	
F-statistic	21.12	

Source: Authors calculation

The results show that audit quality has a negative and statistically significant effect (β = −0.021, t = −3.76), indicating that higher audit quality is associated with a reduction in the dependent variable. Firm size also exhibits a negative and significant relationship (β = −0.018, t = −2.41), suggesting that

Journal of Management Science Research Review

ISSN Online: 3006-2047
ISSN Print: 3006-2039

Volume. 5, Issue No. 2 (2026)

larger firms tend to experience lower levels of the outcome variable. In contrast, leverage has a positive and significant effect (β = 0.034, t = 4.02), implying that highly leveraged firms are more exposed to the measured outcome. Return on assets (ROA) is negatively related to the dependent variable (β = −0.027, t = −2.68), indicating that more profitable firms are less likely to engage in behaviors that increase the outcome. The model explains 33% of the variation in the dependent variable (R^2 = 0.33), and the F-statistic of 21.12 confirms the overall statistical significance of the model.

Earnings Quality and Cost of Capital

Table: 5

Earnings Quality and Cost of Capital

Variable	Coefficient	t-value
Earnings Quality	-0.039	-4.11
Firm Size	-0.015	-2.19
Leverage	0.031	3.84
ROA	-0.024	-2.57
R^2	0.36	
F-statistic	24.65	

Source: Authors calculation

The results indicate that earnings quality has a negative and statistically significant effect on the dependent variable (β = −0.039, t = −4.11). Firm size is also negatively and significantly related to the outcome (β = −0.015, t = −2.19), while leverage shows a positive and significant association (β = 0.031, t = 3.84). Return on assets (ROA) exhibits a negative and significant effect (β = −0.024, t = −2.57). Overall, the model explains 36% of the variation in the dependent variable (R^2 = 0.36), and the F-statistic of 24.65 confirms the overall statistical significance of the model.

Mediation and Crisis Moderation Effects

Table: 6

Mediation and Crisis Moderation Results

Effect	Coefficient	Significance
Audit Quality → Earnings Quality	0.087	Significant
Earnings Quality → Cost of Capital	-0.039	Significant
Audit Quality → Cost of Capital (Direct)	-0.021	Significant
Audit Quality × Crisis → Cost of Capital	-0.018	Significant
Mediation Type	Partial	

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Volume. 5, Issue No. 2 (2026)

Source: Authors calculation

The results indicate that audit quality has a positive and significant effect on earnings quality (β = 0.087), while earnings quality is negatively and significantly associated with the cost of capital (β = −0.039). Audit quality also exerts a negative and significant direct effect on the cost of capital (β = −0.021), suggesting that high-quality audits reduce financing costs beyond their impact through earnings quality. The interaction between audit quality and crisis periods is negative and significant (β = −0.018), indicating that the cost-reducing role of audit quality is stronger during crises. Mediation analysis reveals partial mediation, implying that earnings quality transmits part—but not all—of the effect of audit quality on the cost of capital.

Hypothesis result

Table: 7

Hypotheses Testing Results

Hypothesis	Relationship Tested	Direction
H1	Audit Quality → Earnings Quality	supported
H2	Audit Quality → Cost of Capital	supported
H3	Earnings Quality → Cost of Capital	supported
H4	Mediation: AQ → EQ → COC	Partial Mediation
H5	Moderation: AQ × Crisis → COC	Supported

Source: Authors calculation

All hypothesized relationships are supported. H1 shows that audit quality positively affects earnings quality. H2 and H3 indicate that audit quality and earnings quality both significantly reduce the cost of capital. H4 reveals that earnings quality partially mediates the relationship between audit quality and the cost of capital. H5 demonstrates that the interaction between audit quality and crisis periods significantly influences the cost of capital, confirming the moderating effect.

Discussion

This section examined the relationships among audit quality, earnings quality and the cost of capital in Pakistani non-financial firms during financial crises. The results demonstrate that audit quality has a significant positive impact on earnings quality, indicating that reputable auditors effectively constrain managerial opportunism and enhance the reliability of financial reporting. Firms audited exhibit lower discretionary accruals, highlightingmonitoring role of high quality audits in emerging markets, where regulatory oversight is often limited.

Audit quality also negatively affects the cost of capital, showing that credible audits reduce information

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ISSN Online: 3006-2047
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Volume. 5, Issue No. 2 (2026)

asymmetry and perceived investment risk. Similarly, earnings quality is negatively associated with financing costs, suggesting that reliable earnings reports enhance investor confidence and lower the required returns from equity and debt holders. Mediation analysis indicates that earnings quality partially transmits the effect of audit quality on the cost of capital, confirming that audits not only directly influence financing costs but also do so indirectly through improved financial reporting reliability.

The interaction between audit quality and financial crises demonstrates that the effect of audits is more pronounced during periods of economic uncertainty. Firms with high quality audits are better able to maintain investor trust and access capital at lower costs during crises. These findings collectively highlight the critical role of audit quality and earnings reliability in stabilizing capital market outcomes, particularly in emerging economies such as Pakistan.

It confirms that audit quality strengthens financial reporting, reduces the cost of capital and mitigates risks associated with economic instability. These results have significant implications for regulators, policymakers and firms, emphasizing the importance of promoting high quality audits and transparent financial reporting ensure market efficiency and financial stability.

Conclusion

The empirical analysis of this study provides strong evidence on the critical role of audit quality in improving financial reporting and reducing the cost of capital in Pakistani non financial firms, especially during financial crises. The results indicate that firms audited by high quality auditors, significantly higher earnings quality, as evidenced by lower discretionary accruals ($\beta = 0.087$, $t = 4.21$, $p < 0.01$). This finding confirms that reputable auditors enhance the reliability of financial statements by constraining managerial opportunism, aligning with prior research in emerging markets and developed markets.

Audit quality also has a significant direct effect on the cost of capital ($\beta = -0.021$, $t = -3.76$, $p < 0.01$), indicating that firms with high quality audits benefit from lower financing costs. Earnings quality is negatively associated with the cost of capital ($\beta = -0.039$, $t = -4.11$, $p < 0.01$), implying that reliable earnings reduce perceived risk and required returns from both equity and debt holders. These findings confirm that financial reporting quality is a crucial determinant of firm financing costs.Mediation analysis demonstrates that earnings quality partially mediates the effect of audit quality on the cost of capital (indirect effect $\beta = -0.012$, $t = 3.58$, $p < 0.01$).

This highlights that one of the primary mechanisms through which audit quality influences financing costs is by improving earnings reliability. At the same time, the partial nature of the mediation suggests that other factors, such as firm reputation, corporate governance practices and market perception, may also contribute to the reduction in capital costs.

Additionally, the interaction between audit quality and financial crisis periods is statistically significant ($\beta = -0.018$, $t = -2.95$, $p < 0.01$), indicating that the benefits of high quality audits are more pronounced during periods of economic uncertainty. During crises, investors and creditors are more sensitive to information asymmetry and risk, making reliable financial reporting and auditor credibility essential in maintaining market confidence and ensuring access to capital at lower costs. This finding supports prior research suggesting that audit quality serves as a stabilizing mechanism during economic downturns.

Collectively, the results demonstrate a robust chain of relationships: high quality audits improve earnings reliability, which in turn reduces the cost of capital, with the effect amplified during financial crises. These findings have important implications for regulators, policymakers, corporate managers and investors. Regulators should emphasize the adoption of high quality audit practices, including international standards compliance and auditor independence, to strengthen market confidence. Corporate managers should prioritize transparent reporting and engagement with reputable auditors to reduce financing costs. Investors and creditors can benefit from relying on high quality audited financial statements when making investment and lending decisions, particularly in emerging market contexts.

This study underscores that audit quality and earnings quality are central to enhancing financial transparency, reducing information asymmetry and improving capital market efficiency in Pakistan. By demonstrating that the effects of audit quality are both direct and indirect and are magnified during crises, the study provides comprehensive empirical evidence of the importance of credible auditing in supporting corporate governance, financial stability and investor protection in emerging markets.

Recommendations

Based on the empirical findings of this study, several recommendations can be made to enhance corporate governance, financial reporting quality and capital market efficiency in Pakistan:

1. Strengthen Audit Quality and Oversight

Regulators and standard-setting bodies should promote higher audit quality by enforcing stricter auditor independence requirements, audit rotation policies and adherence to international auditing standards (ISA). The evidence shows that firms audited by high quality auditor's report more reliable earnings and incur lower financing costs, particularly during financial crises.

2. Encourage Engagement with Reputable Auditors

Firms especially publicly listed non financial companiesand should prioritize hiring or reputable audit firms. The study demonstrates that audit quality directly reduces information asymmetry and financing costs. Investing in high quality audits provides a tangible financial benefit by lowering the cost of equity and debt.

3. Enhance Earnings Transparency

Firms should implement internal controls and financial reporting policies that improve earnings quality. Reducing discretionary accruals and ensuring faithful representation of economic performance increases investor confidence, which in turn lowers the cost of capital. Regulators could provide guidelines for transparent disclosure practices to standardize reporting quality across firms.

4. Policy Measures during Financial Crises

Policymakers should recognize the amplified role of audit quality during periods of economic uncertainty. Measures such as mandatory high quality audits for firms accessing capital markets during crises, as well as enhanced disclosure requirements, can stabilize investor confidence and reduce systemic risk.

5. Investor Awareness and Market Education

Investors and creditors should be educated on the importance of audit quality and earnings reliability in evaluating firm risk. By emphasizing the role of audited financial statements in risk assessment, market participants can make more informed investment decisions, promoting efficient capital allocation.

Limitations

This study focuses only on non financial firms listed on the Pakistan Stock Exchange, which may limit the generalizability of the findings to other sectors or countries. The analysis covers a specific period including pre crisis and crisis years, potentially overlooking long term trends. Audit quality is measured primarily by auditor type and earnings quality is proxies by discretionary accruals, which may not capture all dimensions of reporting reliability. Data are drawn from publicly available financial statements and audit reports, which could contain reporting errors or omissions. While panel regression and mediation analyses are applied, causality cannot be fully established and unobserved factors may influence the results. Other potential mediators, such as corporate governance or investor protection,

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were not included, limiting the comprehensiveness of the model.

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