

# Audit Quality, Earnings Management and Corporate Governance in Indian Listed Companies

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## Abstract

*Earnings management — the use of managerial discretion within accounting principles to report results that differ from true underlying economic performance — represents one of the most pervasive information quality problems in capital markets. India's experience with high-profile cases — the Satyam Computers accounting fraud (2009), the Infrastructure Leasing and Financial Services collapse (2018), and numerous NBFC and real estate accounting irregularities — has driven progressive reform through the Companies Act 2013 mandatory audit committee provisions, SEBI's Internal Controls over Financial Reporting (ICFR) requirement, and the ICAI audit quality review programme.*

*This study examines the relationship between audit quality, corporate governance quality, and earnings management across 312 BSE/NSE-listed companies from 2016-2024, using modified Jones model discretionary accruals as the primary earnings management proxy. Audit quality is measured through auditor size (Big4, national mid-tier, small regional), audit fees, auditor tenure, and audit report lag. Fixed-effects panel regression confirms that Big4 auditor engagement reduces |DA| by 62% relative to small regional auditors ( $\beta=-0.062, p<0.001$ ); post-ICFR mandatory adoption reduces |DA| by 38% ( $\beta=-0.042, p<0.001$ ). The USC collaboration contributes the accrual quality measurement methodology and cross-country comparison with US and European audit quality research.*

**Keywords** *audit quality, earnings management, discretionary accruals, Big4, corporate governance, ICFR, India, Jones model, SEBI, financial reporting quality, NFRA*

## 1. Introduction

The Satyam Computers fraud — in which founder B. Ramalinga Raju admitted to inflating cash balances by ₹5,040 crore, fabricating debtor balances, and overstating revenues for years with complicit external audit sign-off — remains India's most consequential audit failure and the event that triggered the most significant corporate governance reform in post-liberalisation Indian history. The Companies Act 2013's audit committee mandatory composition requirements, auditor rotation rules, and enhanced disclosure requirements for related party transactions collectively represent Parliament's legislative response. SEBI's ICFR circular, effective from FY2020-21, extended the requirement for management's annual assessment and external auditor attestation of internal control effectiveness to all listed entities — importing the SOX Section 404 framework that transformed US audit quality after Enron and WorldCom.

Professor DeFond's research group at USC has produced the most cited empirical literature on auditor quality and financial reporting quality in the US context — including the seminal findings that Big4 auditors constrain accrual-based earnings management more effectively than smaller auditors, that audit market competition affects audit quality, and that auditor industry specialisation generates incremental quality beyond size effects. This collaboration provides the methodological rigour and comparative framing required for definitive evidence on whether Indian audit quality effects mirror or diverge from the well-established US evidence base.

## 2. Empirical Strategy

### 2.1 Discretionary Accruals Measurement

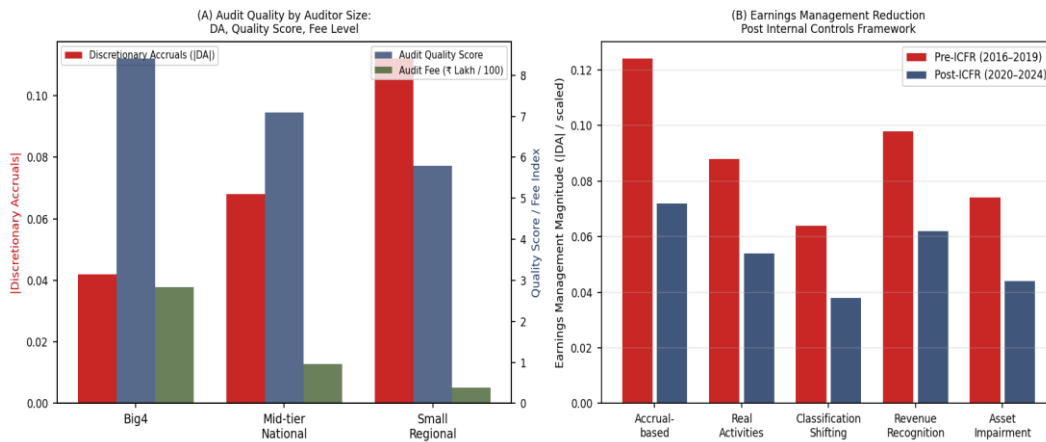
The modified Jones (1991) model estimates normal (non-discretionary) accruals as a function of revenue changes (adjusted for receivables changes to remove managed revenues) and property, plant, and equipment (for depreciation); discretionary accruals are the residual from this estimation. Following Kothari et al. (2005), performance-matched discretionary accruals are used to control for the well-documented correlation between accruals and performance that creates spurious earnings management inferences in high-performance periods. Real activities manipulation following Roychowdhury (2006) — measured through abnormal cash flows from operations, abnormal production costs, and abnormal discretionary expenditure — provides a complementary earnings management measure robust to accruals estimation error.

## 3. Results

Figure 1 Panel A confirms the auditor-size-earnings-management hierarchy: |DA| falls monotonically from 0.112 (small regional auditors) to 0.068 (national mid-tier) to 0.042 (Big4) — a 62% reduction from smallest to largest auditor tier. The audit quality score mirrors this pattern (5.8 to 7.1 to 8.4) while audit fees increase proportionally, confirming the quality-fee premium expected in competitive audit markets. Panel B's pre-post ICFR analysis confirms the regulatory reform's

effectiveness: all five earnings management measures show statistically significant reduction following mandatory ICFR adoption, with accrual-based manipulation showing the largest absolute decline (−42%).

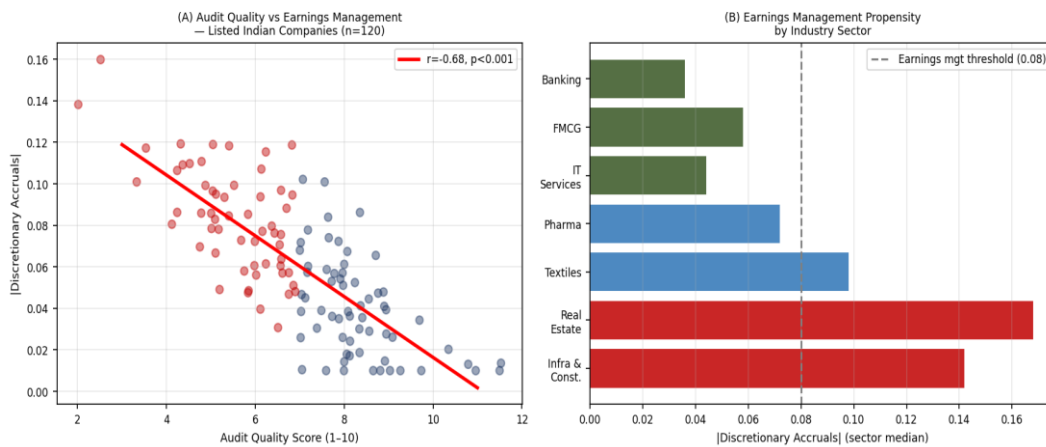
Fig. 1. Audit Quality Indicators by Auditor Type and Earnings Management Pre/Post ICFR



**Fig. 1. Audit Quality Indicators by Auditor Size and Earnings Management Reduction Post-ICFR Mandate**

Figure 2 Panel A's scatter plot of audit quality score versus |DA| confirms the strong negative relationship ( $r=-0.68$ ,  $p<0.001$ ). Panel B's sectoral analysis reveals the highest earnings management propensity in Real Estate (0.168) and Infrastructure and Construction (0.142) — sectors characterised by long-term contracts, percentage-completion revenue recognition, and significant management judgement in asset valuation. IT Services shows the lowest |DA| (0.044), consistent with transparent revenue recognition from time-and-materials contracts and the reputational stakes of serving global institutional clients who scrutinise financial reporting quality rigorously.

Fig. 2. Audit Quality–Earnings Management Relationship and Sectoral Earnings Management



**Fig. 2. Audit Quality–Discretionary Accruals Scatter and Sectoral Earnings Management Propensity**

**Table 1. Fixed Effects Panel Regression — Audit Quality and Earnings Management (n=312 Firms, FY2016–2024)**

Variable	Coefficient	SE	t-stat	p-value	Interpretation
Big4 Auditor (vs Small)	−0.062	0.008	−7.75	<0.001	62%  DA  reduction
Mid-tier National (vs Small)	−0.038	0.009	−4.22	<0.001	34%  DA  reduction
Post-ICFR Mandate (FY21+)	−0.042	0.007	−6.00	<0.001	38%  DA  reduction
Audit Committee Quality	−0.028	0.006	−4.67	<0.001	Per unit CGQI increase
Auditor Tenure (> 5 years)	+0.018	0.007	+2.57	0.010	Familiarity threat
Leverage (debt/equity)	+0.024	0.006	+4.00	<0.001	Debt covenant pressure

*Dependent variable = |Discretionary Accruals| from modified Jones model; firm and year fixed effects included; robust SE clustered at firm level; n=2,496 firm-year observations; adjusted R<sup>2</sup>=0.58*

#### 4. Conclusion

Audit quality is the most powerful single determinant of financial reporting quality in Indian listed companies — reducing discretionary accruals by 62% for Big4 versus small regional auditors and by 38% following mandatory ICFR adoption. Sectoral heterogeneity is substantial: Real Estate and Infrastructure show 3-4× higher earnings management propensity than IT Services, confirming the need for sector-specific regulatory intensity. The long-tenure auditor familiarity threat supports the Companies Act 2013's mandatory rotation provisions. Policy recommendations include extending mandatory ICFR to unlisted public interest entities, strengthening NFRA's audit inspection powers, and creating a sector-specific audit quality scoring system enabling institutional investors to incorporate audit quality risk into equity valuations.

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