

**THREE ESSAYS ON EARNINGS MANAGEMENT AND AUDIT QUALITY:  
INSIGHTS AND IMPLICATIONS FOR FINANCIAL REPORTING INTEGRITY**

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## **ABSTRACT**

In recent years, the scrutiny of earnings management has intensified due to significant financial reporting frauds. Managers utilize discretion in financial reporting, altering information to mislead stakeholders and enjoy private benefits at shareholders' expense. Earnings management strategies have shifted from accrual-based to real economic choices, influenced by perceived opportunities and resources. Even the practice of classifying expenses is also prevalent, aiming to manipulate core earnings without affecting net income. Furthermore, the purchase of non-audit services (NAS) reinforces the economic bond between auditors and clients, raising concerns about auditor independence (information asymmetry). Stakeholders, therefore, expect high-quality audits to mitigate information asymmetry. Big 4 auditors are deemed to deliver superior audits due to resource allocation and negotiation advantages, enhancing their ability to safeguard their reputation and provide reliable services. As stakeholders seek reliable audits, the exploration of how high-quality audits moderate various earnings management strategies remains an intriguing avenue in our research. We focus on an emerging market, India, known for its inadequate corporate governance and weak investor protection measures.

Building on the theoretical arguments of the 'threat rigidity' hypothesis that underperforming firms exhibit risk-averse behavior, our first essay investigates the impact of the firm's duration of performance shortfall on their engagement in real earnings management. We hypothesize that when managers continue to face short-term performance pressures, they shift their focus away from aspirational levels, prefer not to engage in strategic actions to address performance shortfalls and engage in opaque actions of real earnings management. We discover that this baseline relationship for business group (BG) affiliated firms is stronger; however, the moderation effect is weaker under stronger corporate governance and the involvement of high-quality auditors.

The second essay investigates whether and how the geographical proximity between auditors and their clients affects earnings management proxied by the classification shifting of expenses. We find that geographical proximity curbs classification shifting of expenses and decreases earnings management by allowing auditors to develop knowledge about the firm and its characteristics (informational advantage). We also find that the impact of geographical proximity on classification shifting is more for the Big 4 auditors, particularly during the period of governance reforms post-2009, as a result of the disclosure of the big accounting fraud at Satyam Computer Services Limited. Finally, we find that the opportunity to curb classification shifting for proximate auditors is more in the case of better-governed firms.

The third essay investigates whether the higher ownership concentration (family firms) has an impact on the NAS. We find that the family controlled and family managed (FCFM) firms are unlikely to avail NAS from their incumbent auditors to avoid impairment of auditor independence. The empirical results are based on a panel data set of Indian-listed firms. Additionally, we find that FCFM firms are unlikely to avail NAS when Big 4 auditors are employed. We also find that the FCFM firms with high audit committee effectiveness are unlikely to avail NAS to signal their auditors' independence (good governance).

The three essays have managerial and practical implications for developing economies characterized by ownership concentration, weak investor protection, weak governance mechanisms, high government interventions, and high information asymmetry. The essays might aid policymakers and regulators in taking action to minimize manipulation activities.

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such possibilities and develop more robust mechanisms to monitor and prevent such actions, as well as provide adequate attention and critical resources to firms that persist under such circumstances.

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Appendix A. Calculation of geographical proximity

<b>Firm</b>	<b>Distance (in miles)</b>	<b>Scaled</b>	<b>Proximity (1- scaled)</b>	<b>Ranking</b>
Adani Power Ltd.	460.59	4.6059	-3.6059 (1 – 4.6059)	2
DLF Ltd.	1064.74	10.6474	-9.6474 (1-10.6474)	3 (least proximate)
GMR Infrastructure Ltd.	12.7449	0.1274	0.8725 (1-0.1274)	1 (most proximate)

Appendix B. Descriptive statistics of geographical proximity

<b>Percentile</b>	<b>Distance (scaled) in miles</b>	<b>Geographical proximity values</b>
1%	0	-9.730966
5%	0.008292	-9.285773
10%	0.046261	-7.729624
25%	1.770867	-6.025646
50%	5.101588	-0.770867
75%	7.28328	0.936362
90%	10.27105	0.977954
95%	10.64745	0.997545
99%	10.93567	1

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## CHAPTER 5

### SUMMARY OF THE THESIS

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#### 5.1 Contributions to the study

The first study aims to contribute to the existing literature on REM and AEM. Firstly, we expand the existing research on REM by adopting a “*threat rigidity*” perspective and exploring how the duration of performance shortfall influences organizational pressure. Previous studies have mainly looked at shareholder pressure or survival pressure to explain continuous performance shortfall and strategic actions (Su et al., 2023; Yu et al., 2019), whereas, by demonstrating how the duration of performance shortfall results in REM, we enhance our understanding of the factors that drive such behaviour during periods of poor performance. Secondly, we contribute to the literature by incorporating the concept of BGs and its temporal dynamics into the “*threat rigidity*” framework. Prior research has primarily focused on assessing the level of performance shortfall within BGs (Goyal & Goyal, 2022). In contrast, our study highlights how the duration of performance shortfall can shape how organizations within these groups respond to performance shortcomings, thereby expanding the applicability of the “*threat rigidity*”. Lastly, we provide a comprehensive perspective on the relationship between the duration of performance shortfall and REM. We do this by uncovering how governance mechanisms and the involvement of high-quality auditors moderate this relationship. This adds valuable insights to the “*threat rigidity*” literature by considering these important but previously overlooked contextual factors. While previous studies have established the relationship between managerial overconfidence and performance shortfall (Schumacher et al., 2020; Ting et al., 2016; Gaba et al., 2023; Tebourbi et al., 2020), our study is one of the first to explore how risk-averse behavior among managers can influence the

duration of performance shortfall and analyze EM through the theoretical lens of the 'threat rigidity hypothesis'.

The second study adds to the literature in four ways. First, it extends the existing literature by investigating geographical proximity based on the need and advantage of classification shifting of expenses. The prior studies investigate the relationship between (AEM) and (REM) (Cohen et al., 2008; Zang, 2012), between AEM and classification shifting (Fan et al., 2010), and among AEM, REM, and classification shifting (Abernathy et al., 2014), without specifically addressing the impact of geographical proximity on classification shifting. Second, the study focuses on the factors that influence EM. Previous research has shown that firm performance, size, leverage, age, growth potential, accounting flexibility, quality of auditors, institutional shareholding, capital intensity, and governance mechanisms impact AEM and REM. We contribute to the literature by demonstrating that the above-mentioned firm characteristics influence a firm's decision based on geographical proximity. Also, our findings show that firm-specific characteristics motivate firms to make important decisions based on the relative advantage of classification shifting. Third, our work adds to the classification shifting literature by focusing on an emerging economy environment, India, and addresses the demand for research in developing countries to identify various factors (determinants) that managers use to manipulate accounts (Bansal et al., 2023). Fourth, we contribute to the policy-making process and provide suggestions to regulatory authorities and standard setters. The relevant accounting standards need to reframe to minimize the opportunities available for classification shifting of expenses. Finally, auditors need to be more proactive in detecting and publicizing such classification shifting of expenses.

The third study adds the literature to FCFM firms and NAS in two ways. First, there are very few evidence which talks about how the FCFM firms will impact NAS in an emerging market. For instance, Khan et al. (2015) find that family firms pay higher audit fees to engage

good quality auditors in Bangladesh. Alhababsah (2019) finds that Jordanian banks prefer companies with high audit fees, which means the audits are of better quality. However, Al-Ajmi & Saudagaran (2011) find that audit and non-audit fees make it harder for people in Bahrain to get loans. Second, the findings will aid practitioners and regulators because the study shows the role of NAS in an emerging economy. This is interesting in light of the India's Companies Act 2013, which governs the provisions of NAS to clients and determines the scope of NAS.

## **5.2. Managerial and practical implications**

The first study intends to provide practitioner implications. Corporate misconduct such as REM is extremely detrimental to the organization's long-term viability and creates legitimacy issues in the eyes of stakeholders (Suchman, 1995). To counteract this, our study suggests that the governing council of firms, such as the board of directors, must pay additional attention to underperforming firms, as a longer duration of underperformance may induce firms to engage in REM, which is detrimental to the long-term viability of organizations (Roychowdhury, 2006; Huang, Roychowdhury, and Sletten, 2020). Regulatory bodies should anticipate such possibilities and develop more robust mechanisms to monitor and prevent such actions, as well as provide adequate attention and critical resources to firms that persist under such circumstances.

The second study has managerial and practical implications for developing economies characterized by ownership concentration, weak investor protection, weak governance mechanism, high government interventions, and high information asymmetry. The study might help policymakers and regulators take action to minimize EM and curb classification shifting of expenses.

The third study has practical and managerial implications at three levels. On the conceptual level, the results contribute to the existing literature of FCFM firms. Particularly, the results show that the role of the auditor as an external advisor and the effects of her or his ability to provide NAS are different for FCFM firms. On the regulation level, the results show that the benefits of purchasing NAS offered by incumbent auditors decreases as exogenous restrictions get stronger (example, engagement of Big 4 auditors). Policymakers and regulatory authorities need to intervene more and reframe relevant accounting standards to minimize the purchase of NAS to increase auditor independence and attract investors. On the management level, the results suggest that FCFM firms should think about the impact of multiple



engagements of their statutory auditors as Section 144 of India's Company Act 2013 talks about putting more limits on the NAS that incumbent auditors can offer. This is likely to force a large number of FCFM businesses to rely less on their statutory auditors as a trusted source of advice.

### **5.3. Scope for future research**

While our study explored that geographical proximity curbs classification shifting of expenses, the potential influence of proximity and regular physical visits on auditor independence remains a limitation. Future research incorporating an analysis of auditor independence can provide a more nuanced understanding of auditor-firm dynamics and their impact on classification shifting of expenses. We have restricted it to the headquarters at audit firm level and client level. Researchers can broaden the scope of our study in the future by including the non-headquarter branches and also verify whether audit associates' older headquarters or main offices continue to be significant to date. Next, future researchers can further investigate the magnitude and type of classification shifting expenses in different sectors. Even, future researchers could examine the other factors that can have an impact on the purchase of NAS. Furthermore, future research could quantify the relative influence of socialization or knowledge spillover and geographical proximity on audit quality. Also, future research could examine the impact of family firm on the purchase of NAS in different sectors. Lastly, future research can further examine the impact of pandemic (COVID-19) on all three studies.