

CAN REPUTED AUDITORS REDUCE EARNINGS MANAGEMENT? A STUDY ON SELECT INDIAN COMPANIES

Somnath Banerjee*

ABSTRACT

Earnings management has a wide presence in the literature of accounting and finance. The factors which have some influence on earnings management have been the key focus of researchers across all countries. This paper attempts to find out whether reputed auditors are capable of reducing or controlling earnings management. The results show an inverse relation between earnings management and reputation of auditors.

Keywords: *Earnings Management, Accounting and Finance, Reputed Auditors.*

Introduction

It is well known that reporting of earning is an important issue of the companies and it is of utmost importance for the investors and all other stakeholders. The intended manipulation of the reported income by the corporate is known as earnings management, Earnings Management encompasses all those creative ways and means of manipulation of accounting which inflates or deflates reported income but remaining within legal boundaries. Many eminent researchers have researched on the methods by which we will be able to estimate the magnitude of earnings management and have given us many models to measure it. Many researchers have taken place to find out the reasons behind earnings management. Many researchers have taken place to examine the efficacy of the models used to measure earnings management. Many other eminent scholars have researched on various factors which may have any influence on earnings management.

The researches on earnings management have depended heavily on the seminal work by Jones (1991) for the famous Jones Model and Modified Jones Model for the model for the measurement of earnings management through computation of the value of the proxy called discretionary accruals. Much later though, one more seminal work of Dechow et.al.(2002) opened up an altogether new approach towards the perspective from which we look at the issue of modeling to capture the earnings management, This new approach introduced the approach of measuring the indicators for quality of earnings where a high quality would mean low earnings management. The relationship of audit qualification and earnings management is evident in the theories coined in by Bartyov, Gull and Tsui (2001). As the Audit committee in most of the countries comprises of independent auditors as majority, famous studies like this has greatly contributed towards the development of the subject like this.

In this paper, we have explored the relationship between the reputation of the auditor and the earnings management in Indian listed firms. For this, we have taken a sample of 527 firm years. We have found significant relationship of earnings management and the reputation of the auditors. It is expected that the audit firms which are of worldwide presence and reputation would ensure more clarity and fairness of financial reports. The firms which are expected to have higher audit quality are Price Waterhouse Coopers, Deloitte, S.R.Batlboi, Lovelock and Lewis. Few Indian Firms which are worth mentioning as per their reputation are M/S Rathee and associates, M/S Chaddha and associates and

* Assistant Professor, Praxis Business School, Kolkata, W.B., India.

S.K.Mittal and Co. These Indian Audit Firms have maintained a very high standard as auditors while they have audited many reputed Government owned public companies in India like ONGC Ltd, NTPC Ltd etc. For information purpose we are presenting here the detailed list of the companies under our discussion and the auditors thereof as stands by the end of 17-18 Financial Year in Table 1.

Table 1: Companies and Auditors in India: Excerpt Report for some well known Indian Firms

Name of the Company	Auditor
ACC Ltd.	RAVI BANSAL
Ambuja Cements Ltd.	M/S RATHEE & ASSOCIATES
Asian Paints Ltd.	B S R & Co. LLP
Aurobindo Pharma Ltd.	S.R. BATLIBOI & ASSOCIATES LLP
Bajaj Auto Ltd.	Dalal & Shah LLP
Bharat Petroleum Corporation Ltd.	M/S CNK & ASSOCIATES LLP
Adani Ports and Special Economic Zone Ltd.	SRBC & Co. LLP
Bharti Airtel Ltd.	M/s. S. R. Batliboi & Associates LLP
Bharti Infratel Ltd.	S.R. Batliboi & Associates LLP
Bosch Ltd.	Price Waterhouse & Co Bangalore LLP
Cipla Ltd.	Walker Chandiook & Co LLP
Coal India Ltd.	M/S CHATURVEDI & Co.
Dr. Reddy's Laboratories Ltd.	S.R. Batliboi & Associates LLP
Eicher Motors Ltd.	Manhar Kapoor
GAIL (India) Ltd.	O. P. Bagla & Co. AND G. S. Mathur & Co.
Grasim Industries Ltd.	G. P. KAPADIA & CO & B S R & Co. LLP
HCL Technologies Ltd.	M/s. S.R. Batliboi & Co. LLP
Hero MotoCorp Ltd.	DELOITTE HASKINS & SELLS
Hindalco Industries Ltd.	SINGHI AND CO.
Hindustan Unilever Ltd.	S. N. ANANTHASUBRAMANIAN & CO.
I T C Ltd.	DELOITTE HASKINS & SELLS
Indian Oil Corporation Ltd.	SUPARNA DEB
Infosys Ltd.	B S R & Co. LLP
Larsen & Toubro Ltd.	DELOITTE HASKINS & SELLS
Lupin Ltd.	DELOITTE HASKINS & SELLS LLP
Mahindra & Mahindra Ltd.	DELOITTE HASKINS & SELLS
Maruti Suzuki India Ltd.	Price Waterhouse
NTPC Ltd.	M/s T. R. Chadha & Co LLP AND M/s PSD & Associates
Oil & Natural Gas Corporation Ltd.	P K F Sridhar & Santhanam LLP AND Lodha & Co.
Power Grid Corporation of India Ltd.	S. K. Mittal & Co AND Parakh & Co. AND Kothari & Co.
Reliance Industries Ltd.	Chaturvedi & Shah AND DELOITTE HASKINS
Sun Pharmaceutical Industries Ltd.	DELOITTE HASKINS & SELLS
Tata Consultancy Services Ltd.	DELOITTE HASKINS & SELLS LLP
Tata Motors Ltd.	DELOITTE HASKINS & SELLS LLP
Tata Power Co. Ltd.	DELOITTE HASKINS & SELLS LLP
Tata Steel Ltd.	DELOITTE HASKINS & SELLS LLP
Tech Mahindra Ltd.	DELOITTE HASKINS & SELLS LLP
UltraTech Cement Ltd.	DC DAVE & CO. AND ND BIRLA & CO.
Wipro Ltd.	KPMG
Zee Entertainment Enterprises Ltd.	FOR MGB & Co LLP
Bharat Heavy Electricals Ltd.	M/s R. J. Goel & Co.
Ashok Leyland Ltd.	M S Krishnaswami & Rajan AND DELOITTE HASKINS & SELLS LLP
Dabur India Ltd.	G. BASU & CO.
Apollo Tyres Ltd.	DELOITTE HASKINS & SELLS LLP
Tata Global Beverage	Lovelock & Lewes
Bata India	M/s. DSP & Associates
Shree Cements	B R Maheswari & Co LLP
MRF	SASTRI & SHAH AND SCA AND ASSOCIATES
TVS Motor Company	A.N. RAMAN AND S. KRISHNAMURTHY & CO
Siemens	
Havells India	S. R. Batliboi & Co. LLP
Oil India	M/S CHANDRA WADHWA & Co. AND M/S N.C BANERJEE & CO.
Voltas	DELOITTE HASKINS & SELLS LLP

Name of the Company	Auditor
Emami	S K AGARWAL & CO.
Exide Industries	S.R.Batliboi & Co. LLP
Piramal Enterprises	Price Waterhouse
Marico	Price Waterhouse
Steel Authority of India	M/s. Singhi & Co. AND M/s. Chatterjee & Co.
India Cements	Brahmayya & Co. AND P.S. Subramania Iyer & Co.
Godrej Industries	
JSW Energy	Lodha & Co.
CESC	Lovelock & Lewes
Pidilite Industries Ltd.	
Tata Chemicals	DELOITTE HASKINS & SELLS LLP
Ceat	S R B C & CO LLP
Hindustan Petroleum Corporation	G.M. Kapadia & Co AND CVK & Associates
NHPC	M/s S.N. Dhawan & Co. AND M/s Gupta Gupta & Associates
Reliance Power	M/s. Pathak H. D. & Associates AND M/s. Price Waterhouse
Biocon	B S R & Co. LLP
Torrent Pharmaceuticals	DELOITTE HASKINS & SELLS
Sun TV Network	M/s S.R. Batliboi & Associates LLP
SRF	M/s Deloitte Haskins & Sells
Gillette India	M/s Deloitte Haskins & Sells
Berger Paints India	S. R. Batliboi & Co. LLP
Castrol India	M/s. SRBC & Co. LLP
Blue Dart Express	Price Waterhouse
Fortis Healthcare	M/s Deloitte Haskins & Sells
Pfizer	
Whirlpool of India	Gary T. DiCamillo
Suzlon Energy	S.R.Batliboi & Co. LLP AND SNK & Co.
Dish TV India	
Honeywell Automation India	Deloitte Haskins & Sells LLP
Future Retail	NGS & CO. LLP
Jindal Steel & Power	Lodha & Co
MindTree	Deloitte Haskins & Sells
Mphasis	S.R. BATLIBOI & ASSOCIATES LLP
Reliance Communications	M/s. Pathak H. D. & Associates AND M/s. B S R & Co. LLP
Tata Communications	S.B. Billimoria & Co.
Sanofi India	Price Waterhouse & Co.
Bharat Forge	S R B C & Co. LLP
Century Textile & Industries	S R B C & Co. LLP
Kansai Nerolac Paints	B S R & CO. LLP
Indraprastha Gas	M/s Chandra Wadhwa & Co.
Relaxo Footwears	Gupta & Dua
Thermax	B. K. Khare & Co.
Dalmia Bharat	S.S. Kothari Metha & Co.
eClerx Services	S. R. Batliboi & Associates LLP
AIA Engineering	TALATI & TALATI

Source: Author's own construction

CEO compensation and the incentive of managers have been the central focus of researches in this area (Gaver *et al.*, 1995 ; Hall & Liebman,1998 ; Jensen & Murphy,1990 ; Mehran, 1995; Ofek & Yermak, 2000). The relationship of earnings management with firm-specific variables has been discussed in various studies which may not be directly related with this research but they are indispensable in this area (Sloan, 1996; Teoh *et al.*, 1998; Bartov *et al.*, 2000; Guidry *et al.*, 1999; Jo & Kim, 2007). The model, method and findings are discussed in the following sections.

Model

To calculate the discretionary accruals , we have used Modified Jones Model. As per the model, first of all the total accrual is to be calculated which is the difference between a firm's total earnings and cash flow from operations. The total earnings of a firm is as reflected in the change in current assets and current liabilities which can also be put as change in working capital level which reflects the net change in the fund flow of the firm. Theoretically as per the model it can be calculated from equation (i)

$$TA_{i,t} = (CA_{i,t} - CL_{i,t} - Cash_{i,t} + STD_{i,t} - Dep_{i,t}) / A_{i,t-1} \dots \dots \dots (i)$$

TA represents total accruals, i is the firm i and t is the year. Δ operator represents a one year change in the variable. CA stands for current assets, CL stands for current liabilities, STD stands for long term debt that comes within current liabilities because of its maturity. Adding STD eliminates that portion of long term debt that because of its maturity comes within the current liabilities. $A_{i,t-1}$ is the lagged size of assets at year $t-1$. TA is the measure of total accruals in firms and the mod value of TA is used as per this model. This shows that all the values of CA, CL, STD, Cash and Depreciation has to be normalized by lagged asset or the asset value of the previous year.

Then one has to calculate non discretionary accruals which are that part of accruals which is beyond the control of the CEO. Modified Jones Model estimates non discretionary accruals as the fitted value from a regression of total accruals on lagged firm size, the change in firm sales and gross property plant and equipment normalized by total firm asset. The following model is used...

$$TA_{i,t} = \beta_0 + \beta_1 \times (1 / A_{i,t-1}) + \beta_2 \times (\Delta REV_{i,t}) + \beta_3 \times (PPE_{i,t}) + \epsilon_{i,t} \quad \text{equation (ii)}$$

The estimated coefficients are then used to construct nondiscretionary accruals according to the following equation.

$$\text{Estimated } NDA_{i,t}^2 = \text{Estimated } \beta_0 + \text{Estimated } \beta_1 \times (1 / A_{i,t-1}) + \text{Estimated } \beta_2 \times (\Delta REV_{i,t}) + \text{Estimated } \beta_3 \times (PPE_{i,t}) \quad \text{.....equation (iii)}$$

The $\Delta REV_{i,t}$ is the change in sales as normalized by lagged assets for firm i and time t and PPE is the gross property plant and equipment again normalized by firm assets. Instead of firm size, the reciprocal of the size is used as that will have the same influence in the regression as the firm size would.

Discretionary Accruals are then measured as the difference between the total Accruals and non discretionary Accruals.

$$\text{Estimated } DA_{i,t} = TA_{i,t} - \text{Estimated } NDA_{i,t}^2 \quad \text{equation (iv)}$$

Methodology and Findings

We have used 527 firm year's data of select listed Indian companies. The quality of auditor has been considered as a categorical variable where, the reputed auditors have been assigned a value of 1 and the others have assigned the value of 0. The Discretionary Accruals has been considered as the dependent variable and the quality of auditors as the independent variable. The regression model in SPSS was used. The coefficient of the variable BIGAUDR (used in SPSS as the variable for auditor's reputation) is -.068. The significance of F value in ANOVA is .000. This shows that the model is well fit. The adjusted R^2 is 7.4 % which is not very high but given the influence of other variables which has not been controlled for as we have used ordinary least square regression method. The coefficients are given in Table 2.

Table 2

Model		Coefficients			t	Sig.
		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta		
1	(Constant)	.166	.008		20.954	.000
	BIGAUDR	-.068	.010	-.275	-6.547	.000

Source: SPSS output.

The model-fit as shown by a very significant value of F statistics in the ANOVA, is presented in Table 3.

Table 3

ANOVA						
	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.599	1	.599	42.867	.000 ^b
	Residual	7.339	525	.014		
	Total	7.938	526			

Source: SPSS output.

The model summary is given in Table 4.

Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.275	.075	.074	.1182340

Source: SPSS output

Conclusion

From the result summary, it can be clearly understood that the reputed auditors reduce the level of earnings management in firms. The big-4 auditors, due to their reputation, do not allow misreporting of income by the managers who have their own interest in doing so. The Panel Linear Model remains as a future scope of this study which may control the effect of other variables in such regression and may result in a higher value of model fit. The role of the auditors is far more important than anything else in maintaining the true and fair view of the financial reporting of the organization. Although it is not directly possible to judge the quality of Auditors but it is noteworthy that in previous years there has been lots of researches related with the quality of audit. The famous Dechow Model in case of earnings management talks about the proportion of earning which is explained by certain financial parameters. There are evidences of research also in the area of audit quality and discretionary accruals. Hence we believe that the greater is the reputation of the auditor, greater is the fairness of reporting which suppresses the chances of earnings management.

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