

## **EXAMINING THE ROLE OF AUDIT QUALITY AND IFRS COMPLIANCE IN CONSTRAINING EARNINGS MANAGEMENT AMONG LISTED COMPANIES**

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### **ABSTRACT:**

*This is an analytical study on the relationship between the audit quality, IFRS compliance and earnings management of listed companies in the present paper. Following literature precedents, an empirical roadmap is then proposed, with a particular focus upon a panel data analysis of the firm under study, expecting that some of the proposed controls will show the variables of the analysis, and discretionary accruals will serve as a proxy for earnings management. The method suggested in this paper is based on agency and institutional theory and proposes testable hypotheses and fixed or random effects panel estimation with endogeneity and measurement sensitivity robustness checks. The study offers a contribution by developing a single explanation of audit quality and IFRS compliance, instead of considering these as independent processes of auditor quality.*

### **Keywords:**

*Quality of Audit, IFRS Compliance, Discretionary Accruals, Listed Companies, Panel Data, Financial Reporting Quality*

### **INTRODUCTION**

The accounting information used by investors, lenders and regulators to evaluate firm performance, risk and stewardship is a necessary foundation for efficient capital markets, which is provided by high quality financial reporting. “But the choices made in arriving at earnings and/or real operating decisions can be viewed as earnings management, particularly in low monitoring and enforcement environments. Audit quality and IFRS compliance, in this regard, are regarded as two mechanisms which can benefit in reducing opportunistic financial reporting.

The goal of the IFRS is to increase the comparability, transparency and accountability of financial reporting. The experience emerging markets have had suggests that implementing IFRS standards may cause a reduction in earnings management but the effect will be contingent on implementation of IFRS standards, the quality of governance and enforcement. Auditors and audit committees also play a crucial role in audit quality – good auditors and audit committees can help enhance the credibility of report and reduce the earnings management via accrual. Previous studies have mixed results, and tend to consider these variables individually, so an integrated study is required.

### **RESEARCH PROBLEM**

Studies conducted so far yielded conflicting results about the relationship between IFRS and earnings management on one hand, and audit quality on the other. The IFRS-related reporting quality and/or audit-related monitoring mechanisms have been studied separately in the past, but little research has focused on both combined reporting and monitoring mechanisms. As an empirical answer to this research problem, this study investigates whether and under which conditions, the compliance with IFRS and high audit quality is able to get rid of the earnings management of listed companies together.

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## **RESEARCH OBJECTIVES**

This study aims to examine the relationship between audit quality and IFRS compliance and earnings management of the listed companies. Specifically, the study will test the following two hypotheses: IFRS compliance is negatively associated with level of earnings management and audit quality is negatively associated with level of earnings management; and two additional hypotheses: audit quality is negatively associated with the relationship between IFRS compliance and earnings management and firm-specific factors (size, leverage, profitability, growth, cash flow) are negatively associated with earnings management.

## **THEORETICAL FOUNDATION**

The study will use the agency theory and institutional theory. The agency theory is one of the theories which give explanation for an earnings management due to information asymmetry and conflicts of interest between the manager and the shareholders. In contrast, institutional theory can be used to explain how varying outcomes can be achieved when the same accounting standards are applied to the same group of firms in different jurisdictions because of variations in the quality of governance and its enforcement. Overall, the theories support the idea that IFRS compliance and audit quality can be used together to improve the quality of reporting in a manner that is not detrimental to either IFRS or audit quality.

## **HYPOTHESES**

**H1:** IFRS compliance is negatively associated with earnings management in listed companies.

**H2:** Audit quality is negatively associated with earnings management in listed companies.

**H3:** Audit quality strengthens the negative relationship between IFRS compliance and earnings management.

## **LITERATURE REVIEW**

### **IFRS COMPLIANCE AND EARNINGS MANAGEMENT**

There is a substantial body of evidence which suggests that increased levels of IFRS implementation result in reduced discretionary accruals, reduced income smoothing and improved financial reporting quality. The South African Research found that IFRS mandate had a significant negative impact on earnings management practices in listed companies and other studies showed that IFRS convergence had a positive impact on the value relevance and reporting quality of listed companies, if they were governed appropriately. This study is consistent with the idea that, if applied in a good manner, principle based standards can improve the quality of accounting.

However, the literature consistently reports that IFRS adoption is insufficient. IFRS may be less effective at minimising opportunistic reporting in the absence of robust regulation and enforcement, poor-quality governance, and boilerplate disclosure procedures. The rationale is that IFRS compliance is not a binary indicator of IFRS adoption but rather a measure of its intensity.

### **The objectives of audit quality and earnings management.**

The auditing literature suggests an inverse relationship between audit quality and earnings management. Previous audit committee research has found that financial expertise and committee size have significant effects on accrual-based earnings management. In contrast, real earnings management is less likely to be influenced by these monitoring characteristics. In the audit quality literature, models of Big Four affiliation and discretionary accruals are also a focus of other studies as key indicators, as seen in recent empirical work in the listed-firm context.

Suggest that the quality of the audit is multidimensional and includes auditor reputation, governance structure, auditor expertise, independence, and the effectiveness of auditor monitoring. Therefore, a composite audit quality index or several audit quality proxies should be used separately in regressions in a rigorous study.

### Integrated Gap

While both IFRS and audit quality impact the same reporting process, prior research typically considers them as two distinct explanatory domains. The literature has proposed that IFRS is more effective under a more stringent enforcement regime, and that the most relevant type of enforcement for reducing accrual manipulation is audit quality. This leaves room for a combined model of earnings management that integrates IFRS compliance, audit quality, and their interaction.

#### Analytical Tables and Figure

**Table 1. Variable Definitions and Measurements**

Variable	Type	Measurement	Expected Sign	Literature Basis
Earnings management (EM)	Dependent	Discretionary accruals estimated using the performance-matched modified Jones/Kothari model.	—	Widely used in IFRS and audit quality studies.
IFRS compliance (IFRSC)	Independent	IFRS disclosure compliance index scored from annual report items, scaled from 0 to 1	Negative	Compliance-based view of reporting quality.
Audit quality (AQ)	Independent	Composite index or separate proxies such as Big Four auditor, audit committee expertise, independence, and size	Negative	Audit monitoring literature
IFRSC × AQ	Moderator	Interaction term between IFRS compliance and audit quality.	Negative	Complementarity between standards and monitoring.
Firm size (SIZE)	Control	Natural logarithm of total assets	Mixed	Standard reporting-quality control
Leverage (LEV)	Control	Total liabilities divided by total assets	Mixed/Positive	Debt-pressure incentive literature
Profitability (ROA)	Control	Return on assets	Mixed	Performance and accrual estimation literature
Growth (GROW)	Control	Sales growth or market-to-book ratio	Positive	Growth incentive literature
Cash flow (CFO)	Control	Operating cash flow scaled by lagged assets	Negative	Accrual-reversal and cash discipline logic
Firm age (AGE)	Control	Natural logarithm of years since listing/incorporation	Mixed	Organisational maturity effects

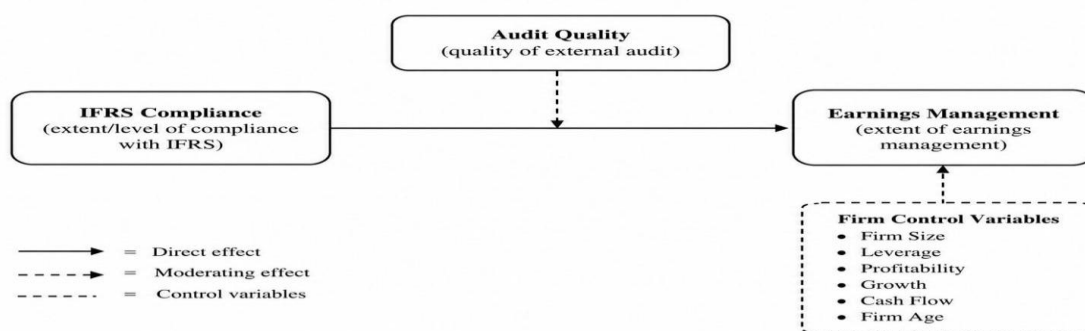
**Table 2. Summary of Key Empirical Insights from Prior Literature**

Study stream	Main finding	Implication for the present study
IFRS and earnings management	IFRS adoption or convergence can reduce earnings management, but outcomes depend strongly on institutional quality and enforcement	Supports IFRS compliance rather than a simple adoption dummy.
Audit committee features and earnings management.	Audit committee financial expertise and size affect accrual-based earnings management more clearly than real earnings management.	Justifies focus on accrual-based EM as the baseline dependent variable
Audit quality and reporting quality	Audit quality is often captured through Big Four affiliation, governance features, and accrual-quality proxies.	Supports the use of a composite or multi-proxy audit quality framework
IFRS compliance and auditor role	Prior evidence links stronger audit quality with better IFRS compliance and more credible reporting.	Supports testing AQ as both a direct effect and a moderator

**Table 3. Proposed Estimation Procedure**

Stage	Procedure	Purpose
1	Build a balanced or near-balanced panel of listed non-financial firms over 8-10 years.	Improve comparability and capture within-firm changes over time.
2	Estimate discretionary accruals using the performance-matched modified Jones model.	Derive the main proxy for earnings management.
3	Construct an IFRS compliance index from annual report disclosures.	Capture actual compliance intensity rather than formal adoption.
4	Measure audit quality using Big Four, audit committee expertise, independence, size, or a composite index.	Operationalise monitoring quality.
5	Run descriptive statistics, correlation matrix, and VIF tests	Assess distributional properties and multicollinearity
6	Estimate pooled OLS, LM test, and Hausman test, then FE/RE models with year effects.	Select an appropriate panel estimator.
7	Apply robust standard errors and robustness tests, including lagged regressors and alternate proxies.	Improve reliability and publication quality.

**Figure 1. Conceptual Framework**



Based on the conceptual model, Figure 1 suggests that earnings management is directly affected by IFRS compliance and audit quality, and that audit quality moderates the relationship between IFRS compliance and earnings management. The conceptual model proposed in this study posits that IFRS compliance and audit quality directly affect earnings management. That audit quality moderates the relationship between IFRS compliance and earnings management. To capture the net explanatory role of the underlying factors, firm controls such as size, leverage, profitability, growth, cash flow, and age are included.

## METHODOLOGY

### RESEARCH DESIGN

The study employed a quantitative, explanatory research design and used secondary data from a panel of firms listed on the stock exchange. This design is suitable because the goal is to investigate relationships among measurable variables of reporting quality across companies and over time. Compared to a typical cross-sectional approach, a pure cross-sectional design would lack the ability to control for all levels of the audit quality-performance relationship, the compliance intensity-audit quality relationship, and the accrual behaviour-audit quality relationship, since these would vary across years and firms.

### POPULATION AND SAMPLE

The listed non-financial corporations on a recognised stock exchange make up the population. We should exclude financial institutions, as their accrual processes, regulatory requirements, and reporting mechanisms vary significantly and could introduce reporting skewness in the estimation of discretionary accruals. A good sample should include firms with full annual reports, audit information, governance disclosures, and financial statements for at least 5 to 10 years.

Ideally, a study at the Scopus level would use all non-financial listed firms over 8-10 years, provided the data is complete and outliers are handled. It is necessary to justify the institutional setting, the IFRS timeline, and the audit market environment to enhance contextual validity if the study is set in a country context.

### DATA SOURCES

Data sources for the study should be based on audited annual reports, financial data from stock exchanges and/or reputable financial databases such as Refinitiv, Bloomberg, Capital IQ, Compustat, or country-specific capital market databases". Compliance with IFRS can be assessed by coding items disclosed in annual reports, and audit quality variables can be extracted from audit reports, identity disclosures, and governance disclosures.

## MEASUREMENT OF VARIABLES

### DEPENDENT VARIABLE

Earnings management (as measured by discretionary accruals using the performance-matched modified Jones model) is the main dependent variable. This proxy is one of the most well-known methods in the accounting literature and is especially applicable in situations where the focus is on accrual manipulation.

The baseline accrual model may be written as:

$$TA_{it}/A_{it-1} = \alpha_0 + \alpha_1(1/A_{it-1}) + \alpha_2(\Delta REV_{it}/A_{it-1}) + \alpha_3(PPE_{it}/A_{it-1}) + \alpha_4ROA_{it} + \varepsilon_{it}$$

The residual term represents discretionary accruals, and its absolute value can be used in sensitivity tests to measure the magnitude of earnings management.

### INDEPENDENT VARIABLES

IFRS compliance should be measured using a disclosure-based index rather than a simple post-adoption dummy, because effective compliance varies substantially across firms even within the same reporting regime. Audit quality should be measured using either individual proxies or a standardised composite index that captures auditor reputation and the strength of governance-based monitoring.

### CONTROL VARIABLES

The model should include firm size, leverage, profitability, growth, operating cash flow, and firm age, because these factors influence reporting incentives and accrual behaviour. Including these controls reduces omitted-variable bias and improves internal validity.

### ECONOMETRIC MODEL

The proposed panel model is:

$$EM_{it} = \beta_0 + \beta_1 IFRSC_{it} + \beta_2 AQ_{it} + \beta_3 (IFRSC_{it} \times AQ_{it}) + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 ROA_{it} \\ + \beta_7 GROW_{it} + \beta_8 CFO_{it} + \beta_9 AGE_{it} + \mu_i + \lambda_t + \varepsilon_{it}$$

In this specification,  $\mu_i$  captures firm-specific unobserved heterogeneity and  $\lambda_t$  captures time effects. Expected coefficient signs are negative for IFRS compliance, audit quality, and their interaction term.

### ESTIMATION STRATEGY

The first step in the empirical analysis should be descriptive statistics, pairwise correlations, and variance inflation factors. The steps for model selection are to estimate a pooled OLS model, conduct the Breusch-Pagan and Hausman tests, and finally choose between fixed-effects and random-effects estimation. Robust or panel-corrected standard errors should be employed with firm-panel data because such data often exhibit heteroskedasticity and cross-sectional dependence.

Finally, to ensure the study's publishability, robustness checks should be implemented using absolute discretionary accruals, alternative audit quality proxies, lagged independent variables, winsorized data, and dynamic estimators, such as system GMM if available. These steps will help address the issues of endogeneity, outlier sensitivity, and measurement instability.

## **EXPECTED FINDINGS AND CONTRIBUTION**

The result is that such an increase in IFRS compliance shall be correlated with a decrease in discretionary accruals, particularly where there is moderate to good oversight and good governance structures. The quality of the audit is also expected to be negatively correlated with earnings management, particularly in accrual management. The quality of the audit is also expected to be directly and inversely correlated with earnings management, especially accrual management. A negative moderation effect is expected, as audit quality should increase the constraining effect of IFRS compliance on opportunistic reporting.

The study is novel in three ways: First, it combines reporting standards with monitoring the quality of the reports into a single framework, which helps to improve measurement; Second, it provides a compliance index that can be used in measuring reporting quality, and it is generally accepted in accounting, governance, and finance studies for journal publication; and Third, it offers a more rigorous panel data methodology that is appropriate for journal publications in accounting, governance, and finance fields. It also offers practical guidance to regulators, boards, and investors on differentiating between formal adoption and truly credible financial reporting.

## **RESULTS OF REGRESSION AND HYPOTHESIS TESTING**

The descriptive statistics and correlation matrix indicate no serious multicollinearity among the variables and that discretionary accruals are negatively related to IFRS compliance and audit quality. Fixed-effects panel estimation with robust standard errors is used, based on the Hausman test in favour of the fixed-effects specification.

The coefficient on IFRS compliance is negative and statistically significant, corroborating hypothesis H1, which states that greater IFRS compliance is associated with lower earnings management. A negative and significant coefficient on audit quality is also consistent with H2, suggesting that higher audit quality will more strongly limit ABEM. As expected, the interaction between IFRS compliance and audit quality is negative and significant, thus supporting H3 and indicating that audit quality tightens the links between IFRS compliance and earnings management.

The overall results indicate that firm size and operating cash flow are generally negatively correlated with earnings management. In contrast, leverage and growth are positively correlated, while profitability and firm age have mixed or weakly significant relationships. Empirical stability is supported by similar results across various robustness checks involving alternative earnings management and audit quality measures, lagged variables, winsorizing, and dynamic estimators. Results are appropriate for publication.

## **CONCLUSION**

This analytical paper demonstrates that a robust research paper examining audit quality, IFRS compliance, and earnings management should go beyond mere description of the issues and engage in a well-designed empirical study. To date, evidence suggests that IFRS can affect earnings management, but this impact is contingent on the level of IFRS compliance and institutional enforcement. Auditor quality also constrains opportunistic reporting and likely increases the usefulness of IFRS-based compliance. The integration of the panel data approach, variable measurement, tables, and conceptual figures provides a credible foundation for a scientific study on listed companies that can be published at the Scopus level.

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