



Earnings management in Indian companies: Post-companies act 2013

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Abstract

The study investigates the extent of earnings management among companies listed on the National Stock Exchange of India. Using a sample of 1005 firms, the study examines the EM practices over a period of six years after the implementation of Companies Act 2013 which has overhauled the country's corporate governance system. The results revealed that the average EM for the six-year period after the implementation of Companies Act 2013 has fallen in comparison to the prior period. The study also analyses the level of EM across firms of different industries and the indicated a high magnitude of average DA for the real estate and construction sectors and a low magnitude of average DA for the communication and transportation service sectors. The study has also shown that there is a direct relation between the size of a company and its EM practice. However, no relation was found between the age of a firm and its EM practice.

Keywords: Earnings management (EM); Discretionary Accruals (DA); Companies Act 2013.

JEL Classification: G30, G39

Introduction

Creative accounting refers to accounting methods that adhere to the norms of conventional accounting practices, yet it deviates from the actual adherence of those rules. It can also be described as a systematic misrepresentation of accounting values by tactically characterizing assets, liabilities, income or expenses and thereby intends to induce the users towards the elucidations desired by the authors. The application of creative accounting has been at the base of many accounting scandals, and many suggestions have been made for an accounting reform that will give a correct depiction of how value is added. The concept of creative accounting, cosmetic accounting, earnings management (EM) or profiteering has been long-established and has been a widely used method for years. One of the most notable activists in the field of creative accounting is Abraham Briloff whose book 'Unaccountable Accounting' analysed the breaches of ethics and audit professionalism and much of what he recommended has been implemented in the industry after the Enron scandal. In 2014, the discussions with external auditors and accountants (Karim, Fowzia, & Rashid, 2014) revealed that the practice of creative accounting is widespread and it is at times considered to be a desirable technique.

Earnings management is a type of creative accounting that involves fraudulent adjustment of earnings or profits through aggressive accounting techniques. This is a type of fraud, therefore, cannot be termed as a

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reporting error. A study by Leoni & Florio (2015) has found that although accounting regulation and financial reporting aims are vastly different throughout the globe, in the case of US and Italy, the use of discretion has been found as the foundation of the earnings management phenomenon. However, countries may have different interpretations of earnings management demonstrating the absence of a universal understanding of the earnings management phenomenon. The flexibility provided by different accounting standards in choosing the accounting method, its application, and timing of events (Ajit, Malik, & Verma, 2013) and the traditional dispute between owners and managers are some of the major factors contributing to EM. When the manager's compensation becomes tied to the firm's performance there arises a direct pressure for managers to indulge in EM. Management desiring to present the earnings at a specific level or according to a specific pattern seeks to find ambiguity in financial reporting standards that may permit them to alter the amounts. Such behaviour is normally influenced by market expectations, maintenance of position within a market sector and personal realisation of a bonus. Aggressive earnings management occurs more when a company is affected by a downswing, in that case, it is quite facile for an auditor to unveil an error but EM can involve intricate fraud that is difficult to discover.

The major accounting scams like Enron, WorldCom and Lehman Brothers scandal and the Satyam scam in India, have led to a massive erosion of investor wealth and has shattered the public confidence in regulators and capital markets. In light of these events, it has become a necessity to evaluate the quality of financial reporting in India and thereby build public confidence and increase investments.

Research on the earnings management of developing countries like India (Ajit, Malik, & Verma, 2013), is becoming significant as there is an ever-increasing demand by the companies for capital from both domestic and foreign markets. An effective flow of investments in India can be ensured only if the investors are safe from frauds, malpractices and other misleading EM practices. Also, a large portion of Indian investors are ignorant and rely solely on financial information provided by the companies for taking various investment decisions, therefore regulators have a responsibility to safeguard these investors. As in the case of consumers, studies (Chapuis, 2012) revealed that EM has a negative effect on consumer satisfaction, however, the total effect will be limited.

Review of literature

The review of literature available on EM has been classified on the basis of EM trend in India, reasons for earnings management, governance and regulatory norms regarding management of earnings and the methods and models of detecting EM. A study examining the degree of earnings management in India (Dayanandan & Sra, 2016) of 1,150 publicly listed companies during 2002–2011 revealed that the average EM in India is 1.5% of the total assets. Another study on earnings management by the SEBI (Ajit, Malik, & Verma, 2013) of 2229 Indian companies from 2008 to 2011 revealed that the average discretionary accruals (DA) of the companies in India are 2.9% of their total assets. A probe into (Mishra & Malhotra, 2016) the level of EM practices in India across firms of varying market capitalization revealed that large-cap companies showed a lower level of EM when compared to the small-cap companies. A sector-specific analysis revealed the presence of higher earnings management in the consumer durable and energy sectors. Researches have also suggested that in comparison to newer firms, the older firms, which have been in the market for longer periods have lesser magnitude of EM, since they might have ameliorated their financial practices over the years (Alaseed, 2006). Moreover, since they are renowned companies they will have a greater reputation and goodwill to protect (Akhtaruddin, 2005). Studies on the relation between firm size and EM (Kim, Liu, &



Rhee, 2003) have revealed that large-sized companies are like to have lesser EM practice as compared to smaller firms since they may have an ineffective control system and more proficient auditors in contrast to small-sized companies. However, a direct link can exist between the size and EM practice when the large-sized companies face more pressures to attain analyst's expectations (Barton & Simko, 2002), moreover, they will have greater bargaining power than smaller firms in negotiation with auditors. Also, as per agency theory, larger entities have high agency cost resulting in more opportunistic earnings practices (Jensen & Meckling, 1976). Another study on earnings management of banks (Shen & Chih, 2005) with a sample of 48 nations showed that EM in banks is quite ordinary and the trend existed for almost all of the sample nations. Findings also reveal that corporates with normal investment are negatively indulged in earnings management whereas, over-invest corporates are inclined to indulge in earnings management (Chu & Song, 2012).

The management may manipulate earnings for various reasons. Important motivations for earnings management (Dechow, Sloan, & Sweeney, 1996) may include the need to raise external finance economically and to avoid debt related constraints. According to Bedard & Johnstone (2004) increased earnings manipulation is related to a rise in planned audit effort, and growing billing rates. The positive link between the billing rate and EM risk is compatible with efforts from the part of auditors. Studies (Bamahros & Wan-Hussin, 2015) have also suggested that companies with longer audit periods have lesser EM. Even though the magnitude of non-audit fees may exacerbate earnings management. There is also evidence (Lee, Lee, & Choi, 2011) that managers are inclined to increase firms disclosed earnings when there is high data asymmetry along with shorter disposition tenure for the stocks received by the managers. There are also studies which revealed that EM on the performance of a stock is minimal and thus has a trivial role in depicting stock returns (Ho & Sia, 2009). The findings of a study done in Taiwan (Tang, 2012) suggested that even though managers might misdirect the investors by accrual based EM during the IPO stage by increasing revenues or prolonging the expenses, issuers cannot sustain their earnings through this practice. Earnings management also arise in response to implicit and explicit benefits availed for achieving certain targets, and therefore earnings falling just short of thresholds may be managed upward and earnings that are far from thresholds, will be reined (DeGeorge, Patel, & Zeckhauser, 1999). This view is supported by another study (Houcine & Halaoua, 2017) which provides evidence that growth opportunities have a positive impact on EM while in thresholds, suggesting that companies may manage earnings around thresholds in a signalling purpose rather than opportunistic one. There is also evidence (Danga, Dang, Le, Nguyen, Nguyen, & Henry, 2018) that companies having high EM have greater firm leverage ratios and that the impact of EM on leverage is more innations that have poor institutional environments.

Studies have suggested that CEOs, with high incentives, whose total compensation is related to company's stock prices directs companies that have higher magnitude of EM (Bergstresser & Philipponb, 2004). Studies (Sun, 2012) also suggest that EM behaviour is likely to be detected when there is an executive compensation contract since CEOs are likely to manage earnings if their compensation is related to the firm's performance. However, there are studies indicating that CEOs tend to avoid EM when the firm's performance is high (Zhang, Bartol, Smith, Pfarrer, & Khanin, 2008). There are also indications that earnings decreases and losses are often adjusted by the managers as reporting of earnings decreases and losses will increase the overall cost of the company in the transaction with its stakeholders (Burgstahler & Dichev, 1997). Studies (Septiari & Maruli, 2017) have also shown that participants under pressure treatment have a lesser tendency to manage earnings than those who did not receive pressure treatment. These findings implied that those having a lower



level of professional fidelity were less likely to indulge in EM when they received pressure treatment. However, a study conducted in Malaysia (Kiattikulwattana, 2014) reveals that there is no strong relationship between management's control on the financial reports and accrual-based EM and that the firms with or without management's responsibility have the same level of accrual-based EM. Studies also reveal that women directors (Abdullah & Ismail, 2016) being there on the audit committees is efficacious in promoting income-decreasing EM practices. A study aimed to examine the importance of board attributes in alleviating opportunistic EM by managers and promoters of firms (Sarkar, Sarkar, & Sen, 2008) indicated that board independence by itself will not bring down absolute DA and also that if a board has busy directors, then absolute DA increases. However, assiduous directors take efforts to reduce absolute DA. Studies also prove that corporate governance attributes are linked to EM (Klein, 2006) and it gives evidence that a CEO being there in the board's compensation committee will have a positive impact on EM and outside shareholder being there on the board's audit committee will lead to a negative impact on EM. These findings indicate that boards that are independent of the CEO are more successful in reducing earnings manipulation. Results of a study conducted in Malaysia (Hashim & Devi, 2008) confirmed that having independent non-executive directors and the role of chairman and CEO being separated, will not reduce the prevalence of EM. Studies (Saleh, Iskandar, & Rahmat, 2005) also revealed that having several directorships are effective to uncover EM practices.

Governments and regulators across the world have taken various measures to control earnings management. Findings revealed that earnings quality increases with tighter standards, even though there may be several consequences that may outweigh this benefit (Ewert & Wagenhofer, 2005). In response to various corporate scams, the Sarbanes Oxley Act (SOX) was passed in the year 2002 (Chan, Farrell, & Lee, 2008). However, studies have revealed that since SOX has made accrual-based EM more expensive, companies have shifted to real EM after the Act was introduced (Cohen & Zarowin, 2008). There are also studies which suggested that subsequent to the implementation of SOX, the level of EM returned to the pre-SOX trend line (Cohen, Dey, & Lys, 2008). Studies also indicate that management ownership may bring down EM practices since it has proved to be an effective control system, particularly for small entities (Ali, Salleh, & Hassan, 2008). An examination of the link between disclosure quality and EM revealed that the degree of EM is negatively linked to the company's disclosure quality (Lobo & Zhou, 2001). However, a study (El-Helaly, Shehata, & Reem El-Sherif, 2018) on 28 countries that analysed the effect of corporate governance on EM revealed that nations that had taken up the Anglo-Saxon system of corporate governance have lesser levels of EM.

There are various methods for detecting EM. Evidence from an analysis of 74 companies that manipulated earnings suggests that accounting data not only provides the necessary financial information, but they also help to make an evaluation of the reliability of the reporting (Beneish, 1999). Earnings management can also be detected through deferred tax expense (Phillips, Pincus, & Rego, 2003). The results of the study done by Stubben (Stubben, 2010) indicates that the discretionary revenue model for detecting earnings management is less biased and better defined in comparison to accrual models and that the estimates from revenue models are useful for detecting EM. A study aimed to evolve empirical techniques to unveil real activities management (Roychowdhury, 2006) revealed that the existence of debts, inventories and growth opportunities are directly related to real activities management. There is also proof of real activities management among the companies trying to circumvent negative annual forecast errors. Studies (Kim, Kim, & Song, 2013) also indicate that financial executives stipulate a greater inclination to manage earnings through real activities rather than accruals as accrual based EM is more probable to attract audit or regulatory attention. The results of a study done on Tunisian firms (Hamza & Bannouri, 2015) also arrived at the same conclusion and suggested that firms are inclined to follow real activities management, in a strict



regulatory environment. There is also a relation between the degree and tenure of overvaluation and alternative EM mechanisms (Badertscher, 2011). Overvaluation is also an important determinant of managements' earnings management decisions.

Various research papers that examined the ability of different models to uncover accrual-based EM and have concluded that Modified version of the model bestowed by Jones provides the most powerful test of EM (Dechow, Sloan, & Sweeney, 1995). Studies also suggested that using a cross-sectional model like Modified Jones Model rather than its time-series equivalents (Bartov, Gul, & Tsui, 2000), will lead to larger sample being less affected by survival bias. According to Chen (Chen, 2010), Modified Jones Model is the optimal method to discern EM in comparison to all the other methods and there is no need to doubt the usefulness of this model.

Objectives of the study

The main objective of this study is to examine the presence and extent of EM in Indian companies. The study seeks:

- (1) To investigate the extent of EM in Indian corporates through DA estimation over a period of 6 years, after the introduction of Companies Act 2013.
- (2) To explore EM practices in different industries.
- (3) To analyse the trend of EM among firms of different age groups and size.

Research methodology

The study has used secondary data which has been collected from the Prowess database maintained by the Centre for Monitoring the Indian Economy (CMIE). The sample universe comprised of all the companies listed in National Stock Exchange (NSE) for a period covering five years, ranging from 2013 to 2018. Of these, financial and banking-related companies were eliminated, as their values tend to vary heavily over time and banking companies have different regulatory and procedural requisites that make them incomparable with others.

Table 1
Sample Formation

Selection Criteria	Number
Total number of companies listed on NSE	1945
Less: Financial and banking companies	230
Total number of non-banking non-financial companies	1715
Less: Companies with limited data to develop all proxy measures	710
The final number of companies used for the study	1005



Modified Jones Model

The Modified Jones model (Dechow, Sloan, & Sweeney, 1995) was used to determine DA. DA is regarded as a proxy for EM. In the first stage, total accruals (TA), is computed as;

$$TA_t = NI_t - CFO_t$$

TA_t = Total accruals in year t,

NI_t = Net Income in year t,

CFO_t = Cash flow from operating activities in year t.

TA_t is then split into NDA and DA using the Modified Jones Model.

$$DA = \frac{TA_t}{A_{t-1}} - \left[\alpha_1 \frac{1}{A_{t-1}} + \alpha_2 \frac{(\Delta REV_t - \Delta REC_t)}{A_{t-1}} + \alpha_3 \frac{PPE_t}{A_{t-1}} \right]$$

TA_t = Total accruals in year t

ΔREV_t = Revenues in year t less revenues in year t-1,

ΔREC_t = Receivables in year t less receivables in year t-1,

PPE_t = Gross property plant and equipment in year t,

A_{t-1} = Total assets in year t-1,

α₁, α₂ and α₃ = Parameters to be estimated, namely alphas,

ε_t = Residuals in year t.

In order to determine the parameters α₁, α₂, and α₃ the following regression equation is used:

$$\frac{TA_t}{A_{t-1}} = \alpha_1 \frac{1}{A_{t-1}} + \alpha_2 \frac{\Delta REV_t}{A_{t-1}} + \alpha_3 \frac{PPE_t}{A_{t-1}} + \epsilon_t$$

To standardise the variability in company size, all the variables are scaled by the total assets at the end of year t-1. The estimates of α₁, α₂, and α₃ are those taken from the Jones Model. The only modification in the modified Jones Model, relative to the original Jones Model is that the change in revenues is adjusted with the change in receivables in the event period to determine non-discretionary accruals.

Positive DAs shows the upward trend of EM and the practice of income-increasing manipulations. Whereas, negative DAs indicates that EM may be in the downward direction and also suggests the likely practice of income-decreasing manipulations

Empirical results

The results of the empirical analysis are obtained using the modified Jones model (1995). The present study stands distinguished from the previous work done in this field in the Indian context, as it examines the prevalence and extent of EM among companies of different industries, age and size. This study is the first to



focus on the level of EM after the enactment of the new Companies Act 2013, along with its stringent provisions for corporate governance.

Table 2 exhibits the descriptive statistics of discretionary accruals (DA) of 1005 publicly listed Indian Companies from 2013-2018 using modified Jones model. The average DA is found to be 2% for the period 2013-2018. This is slightly below the recent estimates of 2.9% average DA (Ajit, Malik, & Verma, 2013) for the period 2008-2011 which was prior to the enactment of Companies Act 2013.

Table 2 Descriptive Statistics

	Discretionary Accruals(DA)	Total Assets (SIZE)
Mean	0.020043	56255.49
Median	0.014191	9129.900
Maximum	2.015793	6183670
Minimum	-0.753105	138.000
Skewness	2.174479	11.91618
Kurtosis	37.42837	198.2635
Std. Dev	0.108515	243333.0
Observations	6030	6030

Table 3 reports the extent of EM prevalent across various industries in the Indian corporate sector. The highest magnitude of earnings management has been recorded in the real estate sector with an average discretionary accrual (DA) of 7.4% followed by the construction industry with a DA of 4.1%. The machinery manufacturing industry and the wholesale and retail sector also has relatively high DA. The lowest level of DA is recorded in the communication and transportation service sector. The electricity generation and the crude oil and natural gas industries which comprise mostly of government-owned companies also showed a relatively lower level of average DA.

Table 3 Industry-wise Average DA

Industry Classification	Average DA	Number of Observations
Manufacturing	1.5%	384
Food and Agro-based	0.4%	444
Textiles	2.9%	966
Chemical and Chemical Products	3.1%	264
Consumer Goods	-0.3%	282
Construction Materials	0.7%	516
Metals and Metal Products	4.1%	312
Machinery	0.1%	468
Transport Equipment	2%	444
Miscellaneous Manufacturing		



Mining	1.8%	84
Coal and Ignite	-0.5%	48
Crude Oil and Natural Gas	6.6%	42
Minerals		
Construction and Real Estate	7.4%	132
Real Estate	4.1%	282
Industrial & Infrastructural Construction		
Electricity	-0.8%	84
Electricity generation	2.8%	78
Electricity transmission and distribution		
Services (Other than financial)		
Hotels and Tourism	-1.2%	144
Wholesale & Retail Trading	4%	288
Transport Services	-1.4%	84
Communication Services	-3.5%	48
Information Technology	5.3%	264
Miscellaneous Services	0.6%	372

Table 4 reveals the level of average DA across the six-year study period, i.e., 2013-2018. The year 2013 shows the lowest average DA at 0.9%. However the following year, 2014 shows a rise in the level of DA. The full-fledged implementation of Companies Act 2013 was in the year 2015, and this may have led to a decline in the average DA for the year 2015 and 2016. The reasons for this could be attributed to the greater public interest, wider disclosure norms, and applicability of stricter corporate governance measures after the implementation of Companies Act 2013. However, there has been a consistent rise in the level of DA in the subsequent years, 2017 and 2018. This increase in earnings management maybe due to the detection of some loopholes in the Act.

Table 4
Year-wise Average DA

Year	Average DA
2013	0.9%
2014	2.6%
2015	1.7%
2016	1.3%
2017	2%
2018	3.2%

Table 5 shows the level of EM among firms of different size. Firms have been classified at a scale 1 to 7 on the basis of 7 deciles as per the information provided by Prowess database. Scale 1 shows the largest company and Scale 7 indicates the smallest companies.



Table 5
Size-wise Average DA

SIZE	Average DA	Number of Observations
Scale 1	2.6%	2898
Scale 2	2.5%	1440
Scale 3	1.4%	738
Scale 4	0.6%	546
Scale 5	-0.1%	306
Scale 6	-4.3%	90
Scale 7	-13.2%	12

Figure 1 presents the trend of companies EM in relation to its size. In a scale of 1 to 7, where 1 indicates the largest companies and 7 indicates the smallest companies, the trend clearly indicates the impact of size on the companies EM practices. As the company's size increases there is an increase in its average DA and as the size decreases the average DA decreases. The trend indicates a direct link between the size of the firm and EM practices and is accordant with the previous researches which reveals that larger entities have higher EM practice in comparison to smaller entities since larger entities confront with a lot of coercion to meet analyst's expectations and they may have greater ability in negotiations with auditors (Barton & Simko, 2002).

Figure 1
Size-wise Average DA

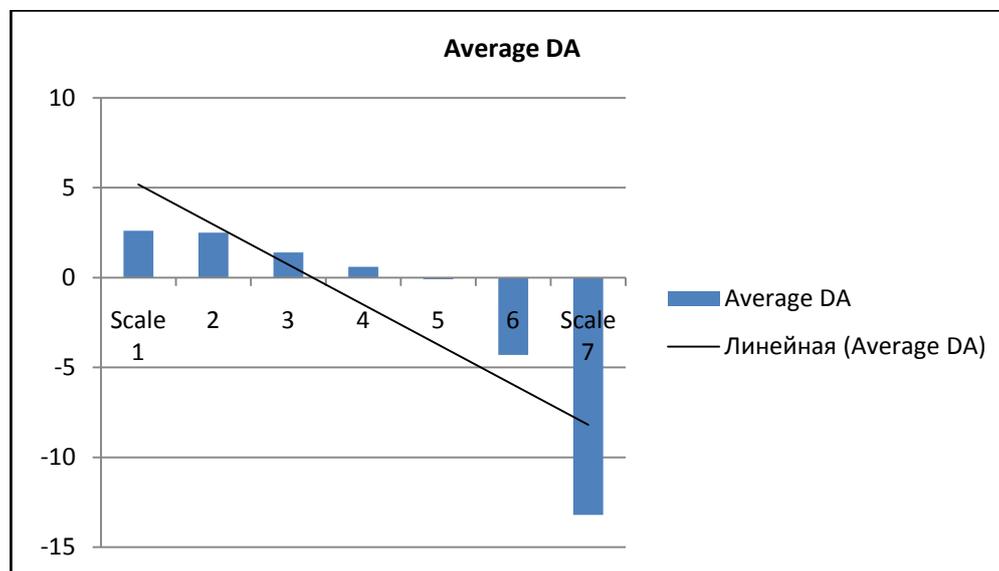


Table 6 shows the level of average DA across firms of different age groups. The estimated Average DA is highest for companies that were established between 1951 and 1971 and lowest for firms established after 1972-1985. The findings reveal that there is no link between average DA and the company's age.



Table 6
Age - wise Average DA

FIRM AGE	Average DA	Number of Observations
Before 1950	2.1%	696
1951 and 1971	3%	828
1972 - 1985	1.3%	1434
1986 - 1990	2.1%	1050
After 1991	1.9%	2022

Conclusion

The paper examines the extent of earnings management practices in Indian companies. The analysis of EM, based on average DA gives evidence that EM is still prevalent, however to a lesser degree. The average DA prevailing across firms for the period 2013- 2018 is 2%. This is lower than the average DA of 2.9% (Ajit, Malik, & Verma, 2013) which is for the period prior to the implementation of companies Act 2013. The efficient corporate governance climate, post Companies Act 2013, may have led to increased transparency thereby reducing the prevalence of EM.

The analysis on the extent of EM prevalent in different industries indicated that the highest magnitude of EM was recorded in the real estate sector followed by the construction sector. The lowest level of DA was recorded in the communication and transportation service sectors. Electricity generation, crude oil and natural gas industries, which consists mainly of government-owned companies also showed a lower level of average DA. The year-wise analysis of average DA revealed a rise in DA in the year 2013 and 2014. However, the year 2015 being the first year of full-fledged application of Companies Act 2013, it showed a fall in the level of DA as compared to the previous years. An analysis based on the size of the firms showed that larger firms tend to have relatively higher average DA as compared to smaller firms. The study also revealed that there is no link between the age of a company and its tendency to manage earnings. Positive DAs indicate not only the upward trend of earnings management but also the practice of income-increasing manipulations. Likewise, negative DAs indicate that EM may be in the downward direction and also suggests the likely practice of income-decreasing manipulations.

This study has applied the modified Jones model (1995), to determine the average DA (taken as a proxy for EM) across different industries in India during the period of 2013-2018.

A weakness of this study is the exclusion of banking and finance companies. There is also scope for further research in real activity based earnings management after the implementation of Companies Act 2013. Despite the limitations, the results obtained from this study may be helpful to managers, practitioners, academicians, researchers and policymakers in many ways.

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