Do Indian Companies Really Manipulate their Earnings?

*Yogesh Sundararajan
**AkshayBhatia

* & ** Class of PGDM 2018, Great Lakes Institute of Management, Gurgaon

This is an investigatory study on how companies manipulate their earnings which emphasizes on the importance of ***'Earnings Management'*** which is an area of great interest to current and potential investors. It is obvious that companies are being hard pressed to deliver returns or earnings as per market expectations to enjoy the privilege of valuation premiums and low cost of capital. However, this eventually pushes investors to resort to shortcuts to manipulate their actual earnings which poses a serious threat to investor's confidence.

'Earnings' which is sometimes referred to as the 'Bottom Line' or 'Net Income' is the most important item in the financial statements. They reveal the extent to which the company is engaged in value added activities. Also, it is a matter of fact that the calculated value of company's shares is nothing but the discounted present value of the future earnings. An increase in earnings indicates a proportionate increase in the company's value. Having said the above, it is critical for any company to understand the effect of their accounting choices which they can make to effectively manage their earnings so that they increase investor's confidence and market capitalization. However, 'Earnings Management' should not be misinterpreted with illegal activities that are used to manipulate financial statements and reporting results that do not reflect the reality. These types of manipulations are known as 'Cooking the Books' or 'Fraudulent Accounting'.

'Earnings Management' which is also commonly referred as 'Window Dressing' or 'Accounting Jugglery' refers to a set of proper and well-defined practices that are a part of well managed business entity which can deliver higher value to the shareholders. Earnings Management is primarily achieved by leveraging Accounting Choices from GAAP or Operating Decisions. Estimating Bad Loans and Provisions and Inventory Write Downs are some of the common practices that are used to inflate financial statements using 'Accounting Choices whereas'Operating Decisions' are whether to offer a special discount or incentive to flush out unsold stocks if revenue targets are not being met.

Earnings Management can be done by manipulating accruals or operational activities of the company. **'Accrual'** is defined as an event that has no impact on the cash flows of the company. A credit sale will result in goods moving out of the company but will not lead to an instant cash inflow. Also, a change in depreciation method on fixed assets will impact the bottom line of the company but will have a neutral effect on cash flow being a cashless expense. These decisions are done at the discretion of the company's management and hence they are called '**Discretionary Accruals'** which are used as proxy for the earnings that are being managed.

It is a matter of fact that Companies continue to manage their earnings to show high top line growth that increases the positioning of the company in the eyes of the shareholders and thus inflating the financial statements. Creating Large Provisions and Cookie Jar Reserves are some of the techniques companies follow to manage their earnings.

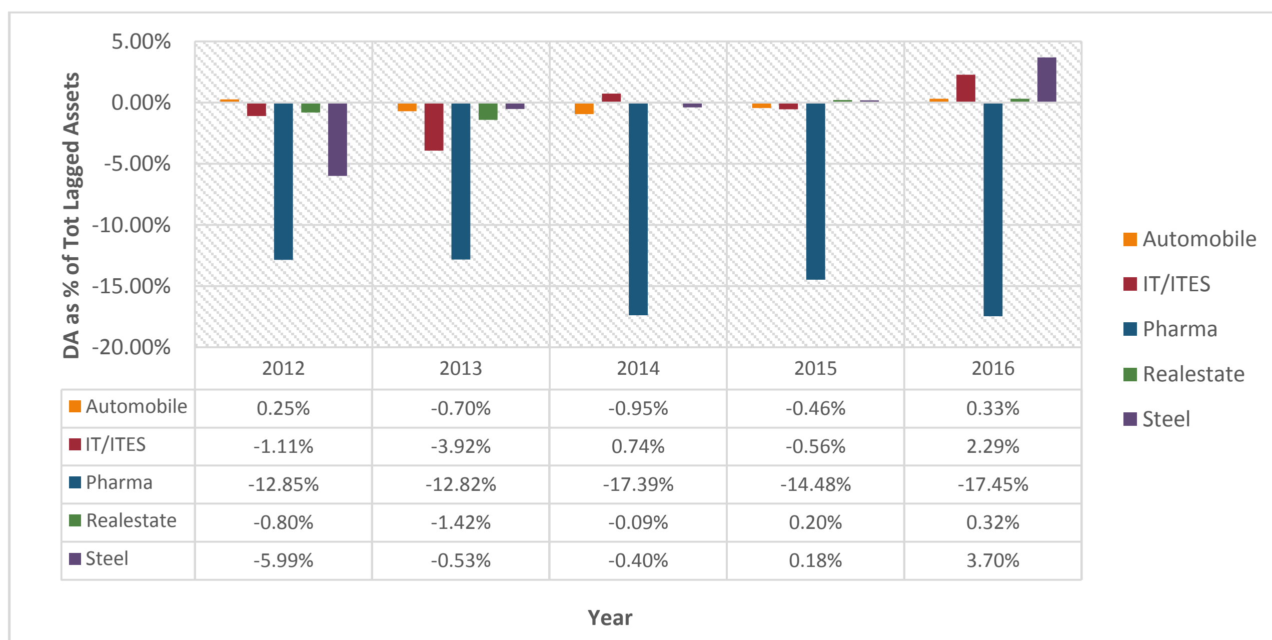
This paper throws light on Earnings Management that happens in Indian Companies across various sectors by altering discretionary accruals. There are prior researches which have used discretionary accruals to detect 'Earnings Management' manipulation namely Healy (1985), De Angelo (1986) and Jones (1991).

The difference between DeAngelo and Healy model is that DeAngelo assumes a random process while Healy model assumes that non-discretionary accruals revert to the previous state. The Jones Model was further extended as 'Modified Jones Model'. However, it has been proved that the 'Modified Jones Model' was more efficient in uncovering the discretionary accruals as it has generated the highest R adjusted value compared to other models. Also, it takes into effect the exogenous effect whereas other models do not take them into account.

It has also been observed that the coefficient for cash sales is positive with increasing income. Further, the multiple regression model (Modified Jones) indicate that the coefficient of PPE has a negative effect on total accruals which implies that decreasing income has a negative effect on total accruals. Therefore, it indicates that the Modified Jones modified model is the most appropriate model when analyzing earnings management, given time series data. Also, Jones model and modified Jones model reveal that business makes higher average discretionary accrual compared to DeAngelo and Healy models.

This research study looks at the financials of 50 companies from 5 independent industry sectors between 2012 and 2016. The study uses the **Modified Jones Model** to compute discretionary accruals.

The Modified Jones Model calculates the Total Accruals and Non-Discretionary Accruals and estimates the Discretionary Accruals as difference between the Total Accruals and Non-Discretionary Accruals. Discretionary Accruals may be positive or negative. A positive discretionary accrual means earnings are being overstated than actual numbers and a negative discretionary accrual means that companies are understating their earnings which they usually do when they have met their revenue and profit targets for the year and wanted to make a provision or take a cushion for the next period.



	2012	2013	2014	2015	2016
Automobile	0.25%	-0.70%	-0.95%	-0.46%	0.33%
IT/ITES	-1.11%	-3.92%	0.74%	-0.56%	2.29%
Pharma	-12.85%	-12.82%	-17.39%	-14.48%	-17.45%
Realestate	-0.80%	-1.42%	-0.09%	0.20%	0.32%
Steel	-5.99%	-0.53%	-0.40%	0.18%	3.70%

The data from the financial statements were plugged in into the Jones Model and Total Accruals and Non-Discretionary Accruals were estimated for each company. The Discretionary Accruals were inferred as the arithmetic difference between Total Accruals and Non-Discretionary Accruals post which the data was consolidated for each sector and mean accruals for each year was computed and the findings were reported based on the assumption that the data from the companies that were taken for study is representative of the entire sector.

It has been proved from our analysis that among the 5 sectors that were taken, **Pharmaceuticals Sector** is showing **mean negative discretionary accruals** of **-15%** over the period of five years. **Steel and IT Services Sectors** have an **average figure of -0.6% and -0.5%** respectively in the same time frame. In the case of IT Services, revenue recognition depends on the management's signoff of project accomplishment and the revenue inflow happens only when the client releases the funds. Two sectors where the understatement of earnings is evidenced by a negative number are **Real Estate** and **Automobile Sectors**.

It is also evident from the above analysis that companies are indulged in earnings management through discretionary accruals. Also, this gives an insight into industry level accruals from the discretionary accrual numbers of the key players whose identities are not revealed here.

This study is a good indicator for regulatory bodies like SEBI and an eye opener for potential investors as well. However, it also puts forward some critical recommendations that SEBI should increase the surveillance and enhance the intensity of monitoring on the companies or industry that are showing a high level of discretionary accruals. Also, this is not only limited to the market regulatory bodies like SEBI. As most of the earnings management is done by company's management, a good board of directors also play a critical role in future valuation of the company which are dependent on potential cash flows and current earnings. Hence, discretionary accruals are reflective of the quality of company's board of director's and audit committees. It is imperative that regulatory bodies increase their surveillance on the effectiveness of these boards and committees. Also, enforcing stringent investor protection laws and accounting standards to protect the interest of minority shareholders can reduce the amount of earnings management.