Opportunistic use of Accrual Earnings in Financial Reporting: A Study of BSE Listed Firmsin India

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Abstract

The study attempted toexplorethe role of discretionary accrualto conceal the actual earnings as a part of misapplication of flexible area in financial estimate in Indian BSE listed companies.As accruals have always provided a common opportunity to deceive financial statements users where the effect causes the financial statements not to be presented, in all material respects,and so along with the H&C (2002) model for total accruals, the most admired DeAngelo (1986)model has been applied for calculatingdiscretionary accruals as part of the treatment for potential earnings management practices for the study. With the sample of BSE listed (industry wise) top 50 companies in India from 2010-2014, an attempt is made to investigatematerial misstatements issue with respect to industry classification on the basis of service and non-service sectors. It is found thatthe service sector industries are involve in income decreasing earnings management practices while non-service sector industries are in reverse practice.Apart from negative correlation between assets size of the firm and discretionary accruals. It isfoundthat the entities of all sizes are susceptible with aberrant pattern anddespite the fact thatthe large firms are engage in income decreasing earnings management practices, on the contrary the small firms aremore likely involve in income increasing practicesin financial reporting of service or non-service sector under which it is operating.

KeyWords: Total Accrual, Discretionary Accrual, Earnings Management, Operating Cash Flow.

1. Introduction:

The changing global business scenario in recent years raise a host of questions regarding earnings management that are of common interest to academia, regulators, and practitioners.Earnings management arises when management utilise their judgement in the flexible areas of accounting in financial reporting and in structuring transactions with the objective of securing private gains. As we are very well acquainted that the professional judgement is very much solicited while applying the accounting standards in preparation and presentation of financial statements, managers are taking such flexible areas and uses their discretion to reap the various financial as well as non-financial incentiveby creating the decorated image of the company that lack economic reality. In this background various previous study had documented the various incentive that managers havewhen dealing with earnings management(Ball et al., 2003; Lang et al.,2006;Bushman & Piotroski, 2006; Burgstahler et al., 2006). In this respect much attention is given both to incentives and economic environmentsthat support those incentives.Earnings management has been defined in many different ways: such as Fields et al (2001), stated that earnings management arises when managers use their choice over accounting numbers with or without restrictions. Such discretion can be either firm value maximizing or opportunistic. Earnings management happens when managers use his personal judgment in financial reporting and in assembling transactions to modify financial reports either to misinform some investors about the fundamental economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy & Wahlen, 1999). Schipper (1989), defines earnings management as the purposeful interference in the external financial reporting process with the objective of private gains. In this study, earnings management is viewed as a deliberate involvement of the external financial reporting process, with the aim of misleading some stakeholders about the underlying economic performance of the company. The recent Satyam Scandals and Sarada Scandals in India; Enron Corporation Scandals, ZZZZ-Best Scandals and WorldCom fall down in United States are the real life veining example of misuse of flexibility in choosing the accounting methods and treatments by the management. Managers mainly participate in earnings management for four kinds of encouragements namely, external contract incentives, management compensation contract incentives, regulatory motivations and capital market motivations (Healy & Wahlen, 1999).That means, all these definitions of earnings management focus on the legal accounting and flexible areas of economic choices that may be used to influence reported earnings.

The remaining paper is structured as follows. **Section 2** summarises the relevant literature related to the objectives of this proposed work and develops the hypothesis. **Section 3**narrates the data and methodology and describes the samples, variables and empirical models to be tested. **Section 4** presents the empirical results while **section 5** concludes the present research.

2. Review of Literature:

Dechow et al.,(1995) Evaluates alternative accrual-based models for detecting earnings management and highlighted the importance of controlling for financial performance when investigating earnings management stimuli that are correlated with financial performance. Islam et al., (2011) examined the effectiveness of Modified Jones Model in detecting earnings management among the initial public offerings of Dhaka Stock Exchange listed companies during 1985 to 2005 and observed that Modified Jones model is not effective in detecting earnings management in the context of Bangladesh. Memis & Cetenak, (2012) Investigates the relationship between earnings management and audit quality across different 8 emerging countries and concluded that only for Brazilian and Mexican companies, there is significant relationship between the discretionary accruals and audit quality but for the other countries there is not significant relationship. Rudra & Bhattacharjee, (2012) investigates the association between adoption of IFRs and Earnings Management and concluded that although accounting standards may control earnings management in some cases, it does not necessarily mean that a country with high-quality accounting standards will also have high-quality reported financial information and thus low earnings management.

Studies conducted by (Burgstahler & Dichev, 1997; Graham et al., 2005; Charitou et al., 2007)on the background earnings management happening and degree invarious economic situations and found that companies manage their earnings when experience somekind of financial difficulty.Lim & Matolcsy, (1999) Observed that the most of the earnings management practices are used in order to obtain advantages from the government. Recently few study documented that the declining of financial performance during the global financial crisis acts like a strong incentive for manager to hide the actual financial performance and thereby engage in earnings management practice in reporting the financial information (Huijgen & Lubberink, 2005; Krishnan, 2007). Jenkins et al.,(2009) Established that conservatism is also one of the important reason for lower level of earnings management. The study of Barth et al., (2008) comprising of 21 countries and study of Marra et al., (2011) observed that adoption of IFRS has a substantial impact on reduction of earnings management practice in financial reporting.Cohen et al., (2008) observed that the passage of Sarbanes-Oxley Act in 2002 has substantially decline the accrual based earnings management but real earnings management practices has increases substantially after 2002.Furthermore few studies were conducted from the standpoint of global financial crisis and its impact on earningsmanagement. For instance the study of (Saleh & Ahmed, 2005; Ahmed et al., 2008)empiricallydocumented thatduring 1997 Asian financialcrisis mangers engaged in more income-decreasing earnings management.Even though there is huge empirical literature of earnings management especially in the perspective of the US, in the Indian context, there are only limited studies have been done (Shen & Chih, 2005; Chipalkatti & Rishi, 2007; Sarkar, Sarkar, & Sen, 2008; and Rudra & Bhattachararjee, 2012; Roy & Debnath, 2015). Shen & Chih, (2005)observed that earnings management to be prevailing among Indian banks. Chipalkatti & Rishi, (2007)Found banks with low profitability indulged in earnings management. Sarkar et al., (2008)documented a negative relationship between board independence and earnings management. Rudra & Bhattachararjee, (2012)found discretionary accruals among Indian firms to be as high as 48.3 percent (of total assets) for 2010.Roy & Debnath, (2015) documented that the service sector industry are more engage in earnings management practice as evident from study of Indian Public Enterprise.

Development of Hypothesis:

Apart from the above issues discussed study there is considerable literaturethat earnings management is significantly linked with the firm's different attributes like Size and sectors under which it is working. Recently (Richardson, 2000;Lee & Choi, 2002) argued that large firms have less encouragement to manage earnings than small firms. Therefore it is hypothesised that

H^1o: There is no association between Earnings Management and Size of the Firm.

In this background to verify the nature and extent of relation of Discretionary Assruals as a proxy to earnings management upon the size of firms present study has used the Pearson Correlation test using the SPSS 20 version.

Generally, service sector firms face higher degrees of environmental uncertainty and a controlled opportunity structure and therefore are more subject to manage earnings than non-service sector firms. therefore firms in service sector generally tend to engage in income-decreasing earnings management while non-service industries are associated with income increasing earnings management (Goel, 2012). Therefore it is hypothesised that

H^2o: There is no relationship between Earnings Management and nature of industry whether service and non service.

Significance of the Study:

Identifying earnings management is one of main challenges for both researchers and practitioners (Dechow et al, 2012); it is neither visible nor transparent. Academicians have formulated indirect methods to estimate earnings management. One widely used method is to gauge the non-discretionary part of accruals. Isolating discretionary and non-discretionary accruals is the most important factor in developing a good earnings management detection model. The difficulty in isolating the non-discretionary and discretionary portions from total accruals by investigators (auditors, analysts, investors, and researchers) makes it convenient for firms looking to engage in earnings management. The analysis of earnings management is often discretionary accruals focused (Dechow et al, 1995; 2012). Keeping these in mind the present study have been designed to explore the magnitude of dictionary accrual part of the earnings as a proxy to earnings management practices carried out in the BSE listed companies in India during the 2010 to 2014.

Objectives of the Study:

The main aim of the study is to assessment and analyse theearnings management practices of BSE listed companies in India. It specifically aims to:

I. Examine the magnitude of discretionary accruals as a proxy to potential earnings management among the different industries under study.
II. Discover earnings management practices furtheramong the units on the basis of service and non-service industry classification.
III. Examine the relationship between firm's size and Discretionary Accruals.

3. Data and Methodology:

Sample Selection: The present study covers BSE listed 50 companies in India from 10 randomly selected industries.Top five (on the basis of market capitalisation) companies has been chosen from each randomly selected industry.Keeping in view the nature of the present study, the main data used is secondary in nature the study employs both accounting and market data collected from moneycontrol.com. The period covered is five years, ranging from 2010 to 2014 as it was considered a reasonably good period to analyse the expected impact of the market conditions on increasing firms' incentive to manage earnings.

Methodology: For the purpose of calculating the average discretionary accruals of each industry aggregate mean value of selected top five (by market capitalization) companies has been taken. Further average assets for five years of study period for each company has been taken as a criteria for determining the size of company.Discretionary accruals act as a proxy to earnings management practice in financial reporting the financial information documented by (Deangelo. 1986; Guay et al., 1996; Sloan, 1996; Subramanyam, 1996; Hong, 2001; Kothari et al, 2005; Ayers et al., 2006; Cohen et al., 2008; Hirshleifer et al., 2009;Baber et al., 2011; Zhang, 2012). By following the stated study the present study shall attemp to examine the earninhs management practice followed in indian BSE listed companies during the study period of 2010 to 2014.Various earnings management models, developed specificallyfor detecting earnings management practices have beenextensively used in the present study. They include thetotal accrual(Hribar & Collins, 2002) model (for calculating total accruals), andthe DeAngelo (1986) model (for calculating discretionary accruals).

Accounting adjustments are known as accruals which are simply the difference between reporting earnings and operating cash flows. Accruals consist of a discretionary portion which is often manipulated by managers and a non-discretionary portion which is dictated by business conditions. In the present study cash-flow approach has been used for the computation of total accrual as suggested by (Hribar & Collins, 2002). This approach calculates accruals directly from the cash flow statement as follows:

$TA = NE – CFOA$

Where, TA is the Total Accrual; NE is the net earnings of the business; and CFOA is the operating cash flows (from continuing operations) taken directly from the cash flow statement.

Since out of total accrual discretionary portion of accruals are used as proxy for earnings management and it cannot be detected directly from financial statements, they have to be estimated using some kind of a model. The DeAngelo (1986) Model is considered here for computing discretionary accruals. It is also referred to as discretionary accrual model. The discretionary portion of accruals in the DeAngelo (1986) Model is the difference between total accruals in the event year t scaled by total assets (A^{t-1}) and nondiscretionary accruals (NDA^{t}). The measure of nondiscretionary accruals (NDA^{t}) rests on the total accruals (TA^{t-1}) of the last period. In other words $DA^{it} = (TA^{t}-TA^{t-1})/A^{t-1}$where, DA^{it} is discretionary accruals for firm i in period t; TA^{t} and A^{t-1} are total accruals and total assets for period t and t-l for firm i.

4. Empirical Results:

Table 1 offers the variables for the analysis of measuring earnings management through discretionary accruals (calculated by the Deangelo, 1986 model) and average total assets as a size of 50 BSE listed companies in India during the study period of 2010-2014.

Table 1: Descriptive Statistics of 50 BSE listed companies during 2010-2014

Statistics	Discretionary Accrual (%)	Size (Total Assets)
Mean	1.93	11574.58
Maximum	70.46	122042.14
Minimum	-6.05	33.39
Observation	50	50

Sources: Authors' compilation from the financial statements of respective companies published by Moneycontrol.com

Table 1 presents the descriptive statistics of average discretionary accruals as a percentage of average total assets of 50 BSE listed companies in the in the Indian during 2010-2014. The average discretionary accruals is estimated at 1.93 percent of the average total assets of Indian companies during 2010-2014, which is almost double of the recent estimates of 1 percent of the total assets in the US context (Sra et al., 2013). The magnitude of discretionary accruals (DA) in the Indian context during 2010-2014 diverse substantially as is evident from the minimum and maximum values of discretionary accruals.

Table 2: Correlations Discretionary Accruals an Firm's Size

		Size	DA
Size	Pearson Correlation	1	**-.138**
	Sig. (2-tailed)		.339
	N	50	50
DA	Pearson Correlation	**-.138**	1
	Sig. (2-tailed)	.339	
	N	50	50

Sources: Authors' calculation

From the Table 2 it is evident that firm's size and earnings management measured by DA has a negative relative relation to the extent of -13.8 percent during the study period this means that the null hypothesis (H^1o) is rejected and leading to the acceptance of the alternative hypothesis is accepted which is in same line of result found by (Richardson, 2000; Lee & Choi, 2002).Table 3 reports the industry-wise picture of discretionary accruals in the BSE listed companiesin Indian during the study period of 2010 to 2014.

Table 3: Industry wise average Discretionary Accruals (DA)

SL. No	Name of Industry	Nature of Industry	No of Observations	Average Discretionary Accruals (%)
1	Aluminium	Non-Service Sector	5	2.04
2	Pharmaceutical	Non-Service Sector	5	1.60
3	Food Processing	Non-Service Sector	5	0.60
4	Domestic Appliance	Non-Service Sector	5	14.59
5	Sugar	Non-Service Sector	5	3.47
6	Paper	Non-Service Sector	5	0.80
7	Chemical	Non-Service Sector	5	0.48
8	Telecommunication	Service Sector	5	-2.38
9	Hospital & Medical Service	Service Sector	5	-0.59
10	Power Generation & Distribution	Service Sector	5	-1.31

Sources: Authors' compilation from the financial statements of respective companies published by Moneycontrol.com

As is evident from Table 3, the highest magnitude of discretionary accruals and hence earnings management was recorded in the Domestic Appliance and Sugar Industry (14.59 percent and 3.47 percent of total assets respectively). The AluminiumIndustry had, on an average, discretionary accruals of the magnitude of 2.04 percent of the total assets followed by Pharmaceutical Industry to the extent of positive discretionary accrual of 1.60 percent and

Paper Industry experience a discretionary accrual to the magnitude of 0.80 percent during the study period. While Food Processing and Chemical Industry has experiences a very low level of positive discretionary accrual at the rate of 0.60 percent and 0.48 percent respectively over the study period. However the Telecommunication, Hospital and Medical Service, and Power Generation andDistribution Industry experienced the negative discretionary accrual during the study period to the extent of -2.38 percent, -0.59 percent and -1.31 percent respectively.

In the earlier discussion, we have observed the discretionary accruals trend in the selected industry under study on individual basis. Now we shall attempt to explore whether the behaviour of managers in the service sector differs from managers in non-service sectors regarding during the study period. Table 4presents the results of magnitude of discretionary accruals as a proxy to earnings management evidence with respect to service and non-service sector classification.

Table 4: Industry wise average Discretionary Accruals (DA)

Service or Non Service Sector	No of Observations	Average Discretionary Accruals (% of total assets)
Non-Service	7	3.37
Service	3	-1.43

Sources: Authors' compilation from the financial statements of respective companies published by Moneycontrol.com

In the non-service sector, all the units are engaged in income-increasing management as it is evident from previous table 3 and thereby the average discretionary accruals of this sector is 3.37 percent of total assets during the study period which is represented in table 4. While in the service sector earnings management trend predicts a negative discretionary accrual performance during the study period, on an average basis because all the industries under service sector are experienced the negative discretionary accrual during the study period as depicted by previous table 3. The average discretionaryaccruals of the service sector is negative to the extentof -1.43 percent which signifies that the nature and extent of earnings management is narrates with nature of industry which lead us to conclude that earnings management practices are somehow dependent on nature of industry classified as service and non-service by rejecting the null hypothesis**(H^2)**. So this leads us to the fact that service sector unlike the non-service sector tends to be engaged in income decreasing earnings management during the study period which is in the same line as observed by (Goel, 2012).

The table 5 presents the average of discretionary accruals (calculated by DeAngelo, 1986 model) of 50 BSE listed Indian firm of different-sized. Here Rs. 11575 crore being the average assets of all the BSE listed 50 firms under study has been taken as criteria for determining the firm's category as Small or Large. If the average total assets of a firm is greater than or equals to Rs.11575 then it is taken as large firm otherwise small.

Table 5 presents the discretionary accruals according to size of the companies under study.

Table 5: Size of Firm and Average Discretionary Accruals

Size of Firm	No of Observations	Average Discretionary Accruals (% of total assets)
Large (Average assets > Rs.11575)	8	-1.80
Small (Average assets < Rs.11575)	42	2.64

Sources: Authors' compilation from the financial statements of respective companies published by Moneycontrol.com

It is evident from the table 5 that, large firms are engage in income decreasing earnings management indicated by negative discretionary accruals to the extent of -1.80 percent of their total assets. While the small firms are involve in income increasing earnings management during the study period as indicated by positive discretionary accruals to the magnitude of 2.64 percent of their total assets.

Conclusions:

Entities of all sizes are at risk and that the discretionary accruals of 50 BSE listed forms during the 2010-14 shows that the estimated average discretionary accruals of the corporate sector in India is 1.93 percent of the total asset (depicted in table 1). Though the group presents the mixed result, study exposes that small firms in India engage in income increasing earnings management to the extent of 2.64 percent of the average total assets during the study period while the large firms are doing income decreasing earnings management to the magnitude of -1.80 percent of the average total assets during the study period (depicted in table 5).So far correlation between firm's size and discretionary accrual (calculated in table 2) is concern, the negative association was found during the study period. Another important findings of the study is that during the study period of 2010-14 all of the non-service sector industries under study experienced the positive discretionary accruals on average basis and all the service sector industries viz; Telecommunication, Hospital and Medical Service, and Power Generation and Distribution experienced negative discretionary accruals as a proxy to earnings management (depicted in table 3). therefore, average discretionary accruals (proxy for earnings management)are negative in case of all the industries working in service sector conversely industry working under the non-service sector experienced the positive discretionary accruals during the study period which indicates that industries under service sector are practicing income dropping earnings management while non-service sector industries are practicing income increasing earning management as evident from the negative average accruals earnings in the case of service sector and positive average accruals earnings to the extent of -1.43 percent and 3.37 percent of total assets respectively during the study period (depicted in table 4).

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