# Abstract

Earnings play a role in capital allocation and any misrepresentation in earnings information could adversely impact the efficiency of the capital allocation process itself, which is a key for economic development. Invested on the basis of wrong information, capital could flow in to undeserving projects and thus hamper economic development in the process. In recent years, there have many instances of corporate accounting scandals followed by a crash in the stock prices, which have led to a large erosion of value for investors. These crashes have generally been attributed to financial misrepresentation by the companies. Most of the new technology sectors started out being overvalued and subsequently there were significant corrections in the market in the year 2000. With increasing compensation being paid by way of executive options, motivation to manage earnings only increases, as an increase in the stock price results in increased value for the manager (Jensen, 2005). Given the link between accounting information and equity valuation, it is likely that managers engage in earnings management with a view to distorting the financial information that a firm provides to its various stakeholders.

This study of earnings management arises primarily because of the accrual system of accounting. One of the methods of earnings management is to manage accruals. Accrual accounting is the method required to be adopted for reporting earnings in various jurisdictions. The alternative to the accrual basis of accounting is the cash basis of accounting. Under the cash basis, revenues are reported when cash is received and payments are recorded only when cash is actually paid out. Cash accounting distorts the reported profits by not matching revenues earned and expenses incurred in that particular

period. With increasing reliance on accrual numbers, it is important that companies provide accurate information about their accrual earnings. The very basis of earnings management arises from the fact that managers have more information about a firm than its owners (investors). Investors value the company based on the information that the managers provide them.

Jensen (2005) brings in a concept of "overvalued equity" where the market valuations of a firm are much higher than its actual value due to various reasons in the market including asset bubbles. He argues that managers do not want investors to have adequate information to value the firm and hence engage in "earnings management" to retain the higher valuation in the market. He cites market valuations as one of the prime reasons for earnings management. Market mechanisms (which would ideally work if a firm were undervalued) fails to remove the valuation problem since investors in the over valued firm do not want to actively reduce the firm value.[1] Equity linked compensation is another motivation, which entices managers to take higher risks in anticipation of higher return. Jensen (2005) points out that the only private solution that to solve the earnings management is the corporate governance system.

India has a unique setting where capital markets are in a relatively developed stage, but most of the businesses/firms are still owned by promoters or a person related to the promoter group, and the shareholding is extremely concentrated. Quarterly results in India are still not required to be audited, providing ample scope for managers to engage in earnings management. Also quarterly results in India are not required to be

[1] Jensen (2004) points out that it is "surprising that short selling has not sorted out the over valuation problem." India currently does not allow short selling of its securities in the cash market.

accompanied by balance sheet information. Recent changes by the Securities and exchange board of India (SEBI) requires auditors to conduct a limited review of the firms' quarterly earnings releases but balance sheet information is still not required to be provided. Earnings play a role in capital allocation and any misrepresentation in earnings information could adversely impact the capital allocation process itself, which is a key for economic development. Invested on the basis of wrong information, capital could easily fall in to wrong hands and thus hamper economic development in the process. In recent years, there have many instances of corporate accounting scandals followed by crash in the stock prices, which have led to a large erosion of value for investors. With increasing compensation being paid by way of executive options, the motivation to manage earnings only increases as an increase in the stock price means an increased value for the manager (Jensen, 2004).

This study addresses the issue of prevalence of earnings management in India and the various factors that induce and mitigate earnings management. India has a unique setting where capital markets are in a relatively developed stage, but most of the businesses/firms are still owned by promoters/ a person related to the promoter group and the shareholding is extremely concentrated. Quarterly results in India are still not required to be audited providing ample scope for managers to engage in earnings management. This study could benefit a variety of stakeholders, including regulators and investors. Regulators can impose stricter restrictions on firms which release quarterly results and could in the future ask for more information from these firms. Firms in specific industries like the high-tech industry could have more opportunity to manage earnings because of their peculiar characteristics such as higher volatility, higher stock based compensation and most of their value coming from future growth opportunities rather than current assets in place. Regulators could requires such firms to report differently since current accounting standards are mostly developed for firms in mature sectors such as the manufacturing sector.