EARNINGS MANAGEMENT IN INDIA: DETECTION, DETERMINANTS, PREFERENCE AND IMPLICATIONS

Abstract

Earnings management (EM henceforth) has been a prominent field of research in accounting. Managers manage earnings by manipulating discretionary accruals and/or manipulating by real/operational activities. This thesis focuses on four dimensions i.e., detection, factors influencing EM with reference to firm specific parameters, managerial preference in EM decision and implication of EM in Indian context.

In detection, the study discusses two dimensions (i) Detection of EM using existing theoretical models covering both accrual-based earnings management (AM) and real earnings management (RM) and, (ii) detection of data anomalies using Benford's Law. Modified Jones (1995) model and Roychowdhury model (2006) are used for measuring AM and RM, respectively. The study finds that Indian companies indulge in both AM and RM. To corroborate that Indian companies indulge in EM, Benford's Law has been tested for detection of anomalies of financial statement items. In Benford's Law, analysis involving first digit, second digit and first two-digit have been considered for this study. With reference to firm specific parameters, such as firm's size, growth opportunities, financial leverage, performance, accounting flexibility, institutional ownership, dividend payout ratio, board size, age, absolute accruals, audit quality and business group affiliation have been considered for studying the impact on AM and RM using panel fixed effect model. The study finds that firms' growth opportunity, financial leverage, performance, institutional ownership, business group affiliation and age influence both AM and RM. With respect to managerial preference, the study explores whether Indian companies choose substitute relationship over complementary relationship between AM and RM. To examine the relationship between AM and RM, two-stage-least square regressions (2 SLS) method is used. The result shows that Indian companies undertake both AM and RM and supports complementary relationship. In implication of EM, the study examines relationship between earnings management and stock price synchronicity using panel fixed effect model. Using earnings management as a proxy for firm specific infromation, the study finds that stock price is more synchronised towards market, and less synchronised towards firm specific information.

JEL classification: M40, M41, G19, G38

Keywords: *Earnings Management, accrual-based earnings management, real earnings management, substitute relationship, complementary relationship, stock price synchronicity.*