Real Earnings Management: Evidence from India

Punita Rajpurohit* and Parag Rijwani**

Financial Reporting Quality (FRQ) is of utmost importance to the investors and regulators because it is a vital input to make investment and credit decisions. Accrual accounting forms the basis of financial reporting. It requires the use of estimates which affect the reported earnings and net assets. In addition to these estimates, real decisions about operational, investment and financing activities can also affect reported earnings. Both—the accounting estimates and real decisions—can be used to misrepresent financial reporting information. The former is referred to as Accruals Earnings Management (AEM) and the latter as Real Earnings Management (REM). Surveys show managers prefer REM over AEM as it is not subject to auditor scrutiny. Thus, it is important to consider REM while assessing FRQ. The study focuses on REM through sales, discretionary expenses, and production costs to assess FRQ. It is found that sample firms engage in REM and also high-performance and growth firms are more likely to manipulate sales and discretionary expenses and less likely to manipulate production costs. Large firms are more likely to manipulate production costs and less likely to manipulate discretionary expenses. Firms with high leverage are more likely to decrease discretionary expenses. Thus, the regulators and investors should take into account both AEM and REM for decision making.

Introduction

India implemented International Financial Reporting Standards (IFRS) convergent accounting standards, namely, Indian Accounting Standards (Ind AS) from the financial year commencing on April 1, 2016. Ind AS 1 states that "the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it."

To achieve the above-mentioned objectives, managers are allowed to use discretion to make accounting choices. These accounting choices involve the use of estimates and judgments.

* Assistant Professor, Institute of Management, Nirma University, Sarkhej-Gandhinagar Highway, Ahmedabad 382481, Gujarat, India. E-mail: punitarajpurohit@gmail.com

** Associate Professor, Institute of Management, Nirma University, Sarkhej-Gandhinaagar Highway, Ahmedabad 382481, Gujarat, India; and is the corresponding author. E-mail: parag@nirmauni.ac.in