

EXPLORING EARNINGS MANAGEMENT PRACTICES IN SELECTED INDIAN PHARMACEUTICAL COMPANIES

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Abstract

Understanding earnings management may also reveal that not all earnings management is bad; so, taking action to uproot the undesirable variety runs the risk of “throwing the baby out with the bath water.” Earnings management does not always have to mean upward manipulation. There can be many instances when managers intentionally misreport earnings downwards. This is especially likely to happen when firms are either way above or way below their targets. The present study aims at examine the magnitude to discretionary accruals with regards to potential earnings management for pharmaceuticals companies. Estimation of DA is carried out using DeAngelo model for this study. The study reveals that most of the units are found to be exercising income-increasing discretionary accruals, as verified by their positive average. Only Cipla Ltd, Sun Pharma Ltd and Torrent Pharma Ltd are exercising income-decreasing management on an average basis.

Key Words : Earnings Management, Discretionary Accruals, De-Angelo Model,

INTRODUCTION

Earnings, the “bottom line” or “net income”, are the single most important item in financial statements. They help in resource mobilization in capital markets. Earnings management occurs when management uses discretion in financial reporting and in structuring transactions with the objective of securing private gains. Earnings management issues related to financial disclosure and reporting are increasingly relevant to the multitude of firm stakeholders. Many reasons could motivate management to manipulate accounting information such as maximizing the wealth of management when bonuses are calculated based on accounting profits. Managers manipulate to minimize financing costs: public offering, mergers and acquisitions and leveraged buy outs. Non discretionary accruals are the accruals which are required by business activities while discretionary accruals consist of accruals which are not required by activities and are indexed as companies’ total assets or sales. Discretionary accruals cannot be observed directly from financial statements; they have to be estimated using some kind of a model. Earnings management, in accounting, is the act of intentionally influencing the process of financial reporting to obtain some private gain. Earnings management involves the alteration of financial reports to mislead stakeholders about organization’s underlying performance, or to “influence contractual outcomes that depend on reported accounting numbers. This study analyses the earnings management practices in India by examining the magnitude of discretionary accruals. For this study De Angelo Model has been used for calculating discretionary accruals in regard to potential earnings management.

REVIEW OF LITERATURE

Syed Zulfiqar Ali shah et al (2010) examined the impact of earnings management on dividend payout policy for two countries that is Pakistan and China. Earnings management has been measured by calculating discretionary accruals. Results of Common effect model shows that for both the countries, earnings management has no impact on dividend payout policy and this enables us to accept two of our hypothesis. However on the basis of these results it was found that third hypothesis has been rejected stating that relationship between earnings management and dividend payout was not same in both countries. **Mahdi Safari Gerayli et al (2011)** provide empirical evidence on the impact of Audit Quality on Discretionary Accruals, as a measure of Earnings Management, in Iranian listed firms, based on a sample of 90 non-financial Iranian listed firms from 2004 to 2009. The study used multiple regression analysis estimating for relationship between the Audit Quality and firm’s Discretionary Accruals. The results revealed that Discretionary Accruals has negatively related to Auditor size and Auditor industry Specialization. **Sandeep Goel (2012)** has analyzed the earnings management practices of corporate enterprises in India. The study specifically aims to examine the magnitude of discretionary accruals in regard to potential earnings management and explore earnings management practices further among the units on the basis of industry classification. DeAngelo Model has been used for calculating discretionary accruals with regards to potential earnings management for the study .The

results revealed that there was definite presence of accrual management in the sample companies and most of the units have been found to be exercising income-increasing discretionary accruals. **Teuta Llukani (2013)** evaluated earnings management initiatives in Albanian context, to identify the relationship between earnings management and firm size using Jones Model. The results revealed that firms in the Albanian market were engaged in earnings management initiatives and there were no significant differences concerning earnings management initiatives and practices amongst large and small size companies. **Sonia Sayari et al (2013)** examined and compared four earnings management measurement models examining Tunisian stock market information content and the ability to forecast managers' behaviour. The study found out that discretionary accruals allow Tunisian investors to better evaluate firm value and optimally form their stocks portfolios. Further, earnings management allows for increasing abnormal positive stocks returns for large Tunisian firms and reducing abnormal negative stocks returns for small Tunisian firms. **Lynda Ioualalen et al (2015)** analyzed the impact of three Audit Committee characteristics, financial expertise, diversity and activism on aggressive earnings management. The study measured earnings management by the level of discretionary accruals using the modified Jones model. The results imply that activism and the financial expertise of audit committee members are inversely related to aggressive earnings management. The results also contribute to help governance oversight organizations in identifying audit committee characteristics that have the most influence on the detection of aggressive earnings management.

RESEARCH METHODOLOGY

The present study is an attempt to demystify practices of earnings management for selected pharmaceuticals companies in India. The basic problem of this study is to see that how company use accounting techniques to produce financial reports. This study also makes an attempt to find out to what an extent company manipulate their earnings.

Objectives of the study:

1. To estimate the magnitude of discretionary accruals with regards to potential earnings management.
2. Explore earnings management practices further among the units on the basis of industry classification.

Sample Size:

To study earnings management of pharmaceuticals sector, 10 listed companies from Indian Pharmaceutical Sector have been selected. The study is based on secondary data for the period of 11 years commencing from 2006 to 2011. They are as follows:

1. Cipla Ltd
2. Lupin Ltd
3. Sun Pharmaceutical Industries Ltd
4. Cadila Healthcare Ltd
5. Divi's laboratories Ltd
6. Dr.Reddy's laboratories Ltd
7. Torrent Pharmaceuticals Ltd
8. Aurobindo Pharma Ltd
9. Biocon Ltd
10. Piramal Enterprises Ltd

Tools and Techniques:

The following DeAngelo model is used to estimate discretionary accruals.

➤ The DeAngelo Model:

The DeAngelo 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 Model is the difference between total accruals in the event year t scaled by total assets (A_{it-1}) and nondiscretionary accruals ($NDAt$). The measure of nondiscretionary accruals ($NDAt$) rests on the total accruals ($TAt-1$) of the last period. In other words,

$$DAC_{it} = (TAt - TAt-1) / A_{it-1}$$

where,

DAC it is discretionary accruals for firm i in period t ;

TAt and A_{it-1} are total accruals and total assets for period t and $t-1$ for firm i .

DATA ANALYSIS & INTERPRETATION

The following table-1 shows the Discretionary Accruals of selected pharmaceutical companies under study.

• **Discretionary Accruals (DeAngelo Model):**

As Discretionary Accruals is a proxy to earnings management, its trend indicates income- accrual management exercised by a company. If the trend in accruals is negative (positive), it indicates managers are making income-decreasing (increasing) accrual decisions. Discretionary Accruals have been computed using the De- Angelo Model.

Table No.: 1: Discretionary Accruals

Years	Cipla Ltd	Lupin Ltd	Sun Pharma Ltd	Cadila Healthcare Ltd	Divi's Lab Ltd	Dr. Reddy's lab Ltd	Torrent Pharma Ltd	Aurobindo Ltd	Biocoon Ltd	Piramal Pharma Ltd
2006	0.0463	0.0836	0.02	0.0752	-0.017	0.11	-0.009	0.06	0.07	0.06
2007	0.0008	0.0354	0.007	-0.0747	-0.028	0.04	0.01	0.05	-0.05	0.003
2008	-0.0026	0.0186	0.051	0.106	0.0578	-0.06	-0.1	0.002	0.1	0.08
2009	0.0143	-0.061	-0.071	-0.0859	0.06	0.03	0.05	-0.01	-0.09	0.09
2010	-0.0546	0.0336	0.038	-0.0313	-0.093	-0.07	-0.05	0.01	0.01	-0.18
2011	-0.0091	0.0537	-0.012	0.0501	0.07	0.13	0.08	0.03	0.04	6.36
2012	-0.0585	-0.0047	0.026	0.065	0.044	-0.12	-0.06	-0.15	-0.003	-1.28
2013	0.0719	-0.0121	0.006	-0.049	-0.029	0.14	0.27	0.06	-0.06	0.05
2014	-0.0478	0.0772	-0.09	-0.005	0.033	0.004	-0.05	0.14	0.07	0.0003
2015	0.0428	-0.142	-0.086	0.026	-0.055	-0.07	-0.21	0.009	0.03	0.13
2016	-0.0302	0.217	0.048	-0.018	0.011	-0.08	-0.02	-0.12	0.12	0.27

1. Cipla Ltd

Chart No : 1

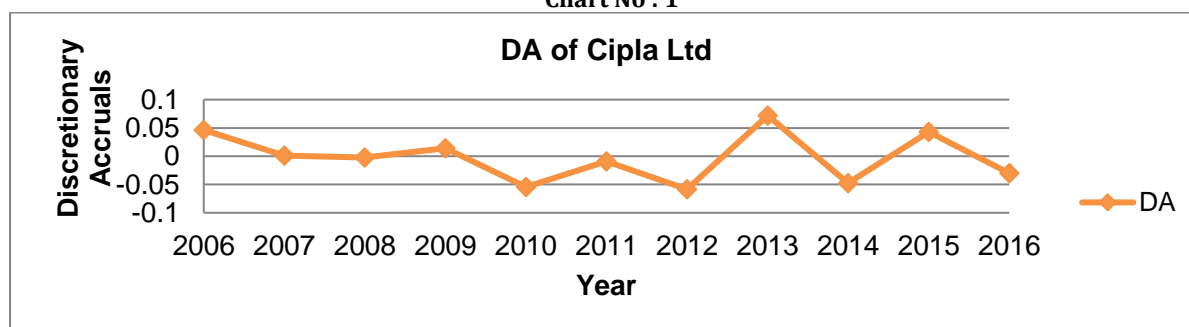


Chart No.-1 shows definite presence of discretionary accruals in Cipla Ltd. The earnings management trend predicts a mixed discretionary accrual performance in Cipla Ltd. It indicates in most of the years company have negative discretionary accruals. Negative accrual trend indicates that managers are making income-decreasing accrual decisions. They are saving for the future. Thus, there is manipulation in financial statement during period of study. While, in rest of the years, it is having positive discretionary accruals indicating income-increasing earnings management.

2. Lupin Ltd

Chart No.: 2



Chart No.-2 presents the trend of discretionary accruals of Lupin Ltd. For the years, 2009, 2012, 2013 and 2015, discretionary accruals have negative trend indicating income-decreasing accrual decisions. During the rest of the years, it has positive discretionary accruals indicating income-increasing accrual decision. Thus, there is manipulation in the financial statement of Lupin Ltd.

3. Sun Pharmaceutical Industries Ltd

Chart No.: 3

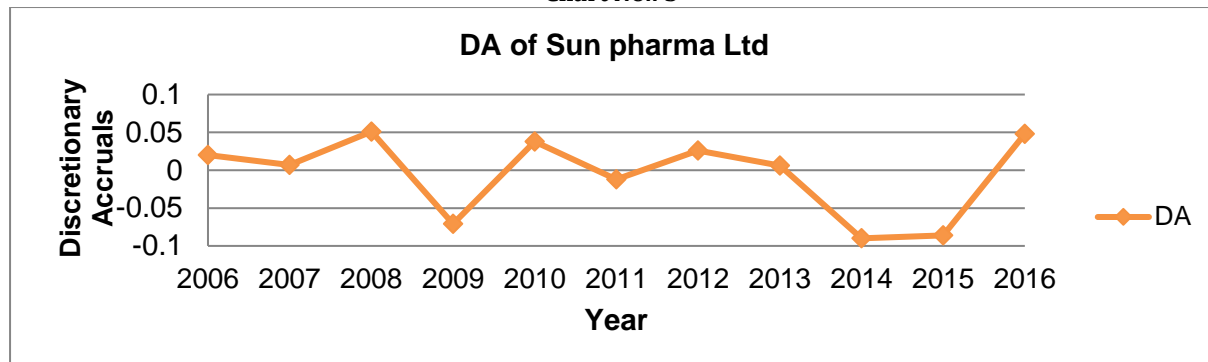
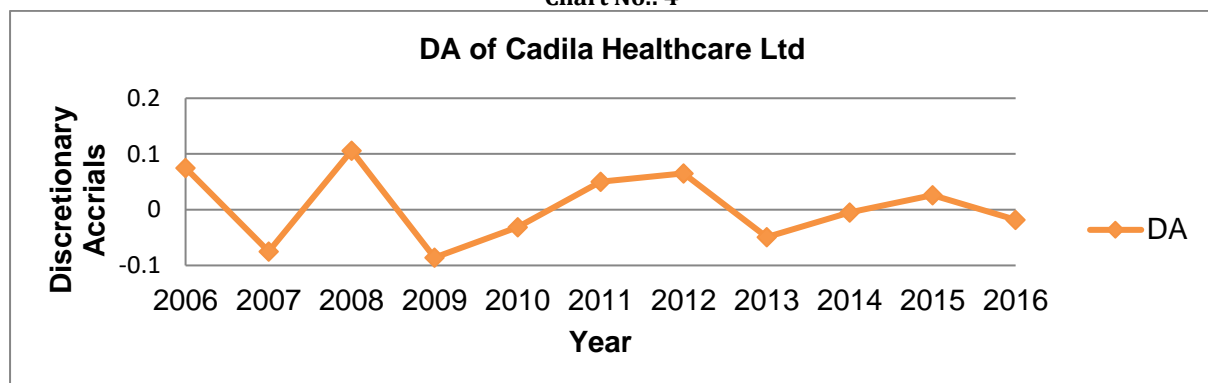


Chart No.-3 indicates that Sun Pharma have negative discretionary accruals in a year 2009, 2011, 2014 and 2015 which shows income-decreasing management. For the year 2006, 2007, 2008, 2010, 2012, 2013 and 2016 have positive discretionary accrual which shows good performance of company. Positive accrual trend indicates income-increasing accrual decisions.

4. Cadila Healthcare Ltd

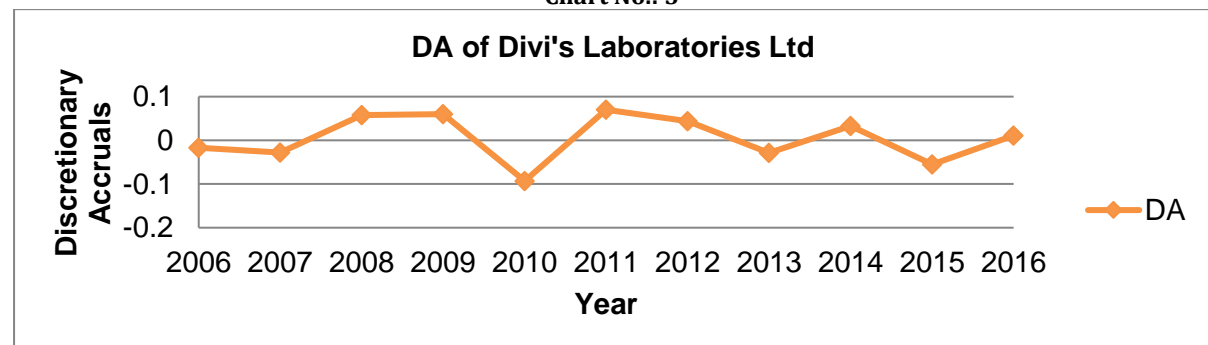
Chart No.: 4



The earnings management trend predicts a negative and positive discretionary accrual performance in Cadila Healthcare ltd. Company have negative discretionary trend in most of the years which indicates that managers are making income-decreasing accrual decisions because they are saving for future. Thus, there is manipulation in financial statement during period of study. Positive trend in rest of the years indicates income-increasing management which present companies performance.

5. Divi's Laboratories Ltd

Chart No.: 5



<https://www.gapgyan.org/>

Chart No.-5 shows definite presence of discretionary accruals in Divi's Laboratories Ltd. In a year, 2006, 2007, 2010, 2013 and 2015 company have negative discretionary accruals which present income-decreasing management. It also shows that company have large fictitious revenue as compared to other years because company are saving for future. In rest of the years, company have positive discretionary accruals which indicate income-increasing accrual decisions by manager.

6. Dr.Reddy's Laboratories Ltd

Chart No.: 6

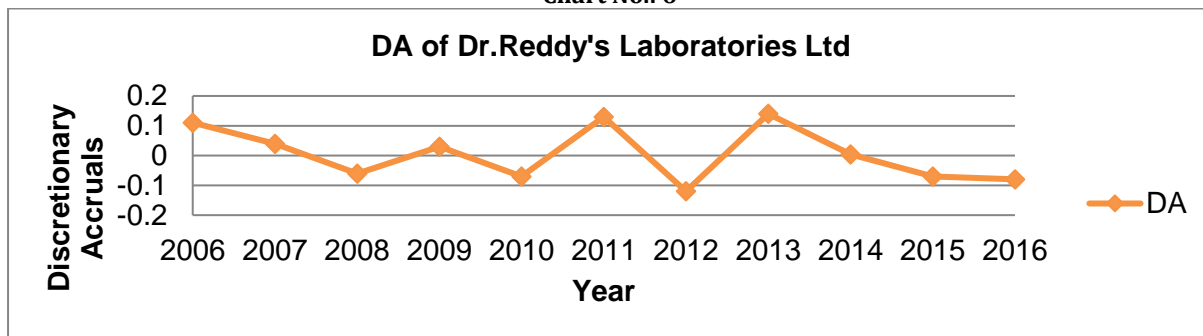


Chart No.-6 presents positive and negative discretionary accruals. It shows that for the years, 2008, 2010, 2012, 2015 and 2016, Dr. Reddy has negative discretionary accruals. If trend of accruals is negative, it indicates that managers are making income-decreasing accrual decisions and it also presents manipulation in financial statement during period of study. For the years, 2006, 2007, 2009, 2011, 2013 and 2014, have positive discretionary accruals which indicate company exercising income-increasing management.

7. Torrent Pharmaceuticals Ltd

Chart No.: 7

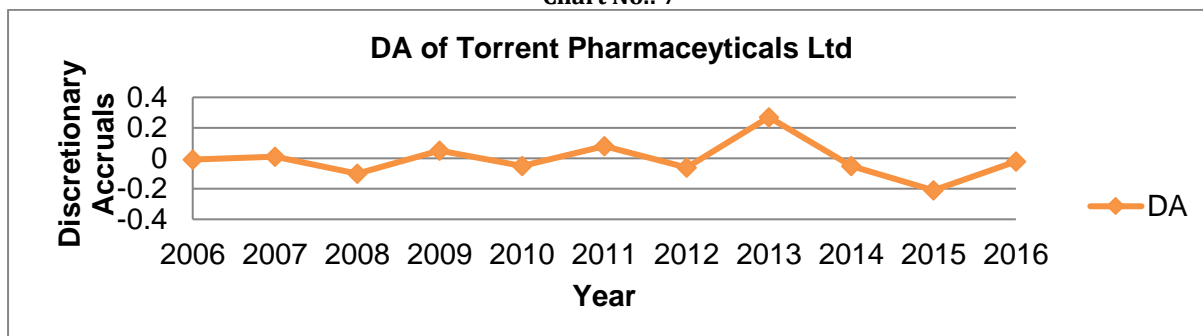


Chart No.-7 shows definite presence of discretionary accruals in Torrent Pharma. The earnings management trend predicts a negative and positive discretionary accrual performance in Torrent Ltd. It indicates in most of the years company have negative discretionary accruals. Negative accrual trend indicates that managers are making income-decreasing accrual decisions. They are saving for the future. While, in rest of the years, it is having positive discretionary accruals so it indicates income-increasing management.

8. Aurobindo Pharma Ltd

Chart No.: 8



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Chart No.-8 shows positive and negative discretionary accruals. For the year, 2009, 2012 and 2016, Aurobindo Pharma has negative discretionary accruals which show that company exercising income-decreasing management. Company is having manipulation in financial statement during period of study. In rest of the years company has positive accruals trend. Positive accrual trend shows that company exercising income-increasing management which shows good performance of company.

9. Biocon Ltd

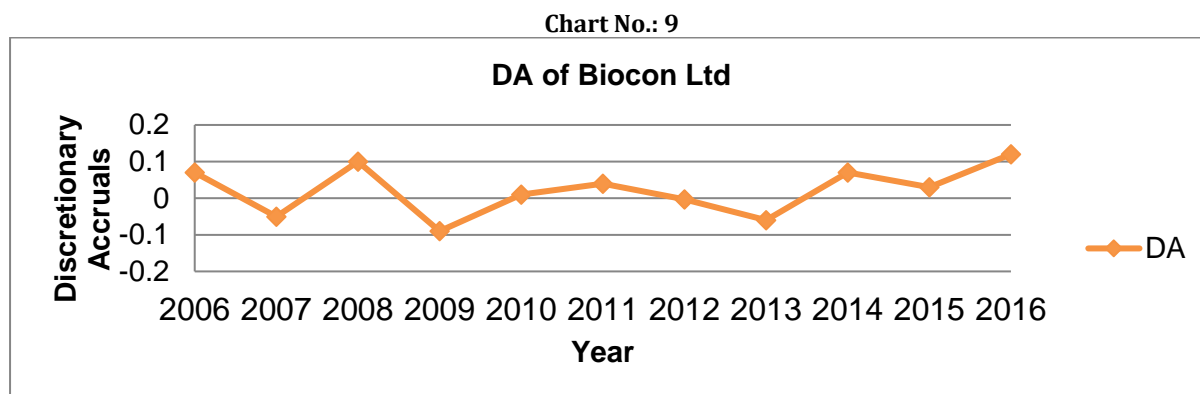


Chart No.-9 shows discretionary accruals of Biocon Ltd. Company have negative discretionary accruals in a year 2007, 2009, 2012 and 2013 which shows manager are making income-decreasing accrual decisions. They are saving for future. For rest of the years, company has positive discretionary accruals it indicates company are exercising income-increasing management.

10. Piramal Enterprises Ltd

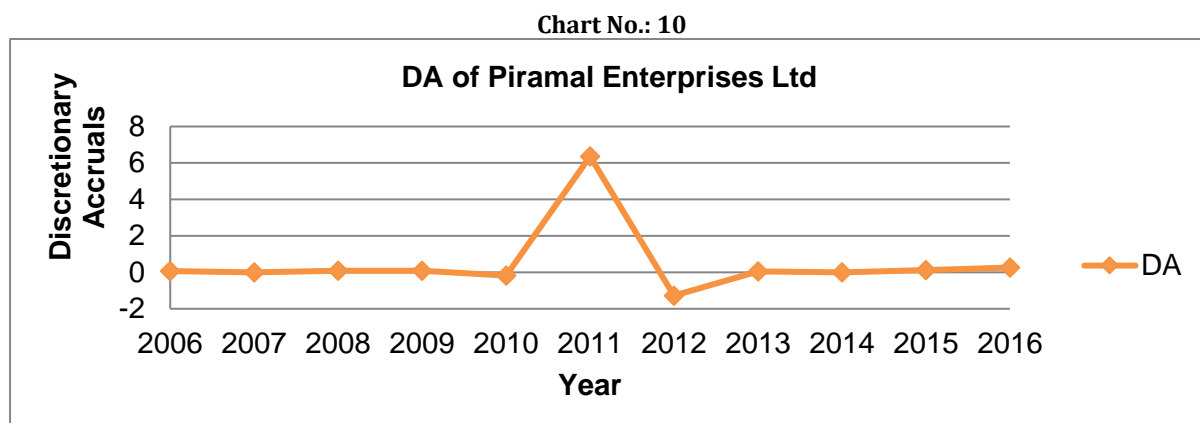


Chart No.-10 presents positive and negative discretionary accruals of Piramal Pharmaceutical Ltd. The earnings management trend predicts a negative and positive discretionary accrual performance in Piramal Pharma Ltd. In 2010 and 2012 company has negative discretionary accruals indicates that manager are making income-decreasing accrual decisions. There can be chances of manipulation by the company. In rest of the years company has good performance because discretionary accruals have positive trend which indicates that company exercising income-increasing management.

Table No.: 2: Average Discretionary Accruals

Company	ADA
Cipla Ltd	-0.0024
Lupin Ltd	0.0272
Sun pharmaceutical Industries Ltd	-0.0057
Cadila Healthcare Ltd	0.0053
Divi's Laboratories Ltd	0.0049
DR.Reddy's Laboratories Ltd	0.0049

Torrent pharmaceuticals Ltd	-0.0081
Aurobindo Pharma Ltd	0.0074
Biocon Ltd	0.0215
Piramal Healthcare Ltd	0.5075
Average	0.05625

Chart No.: 11

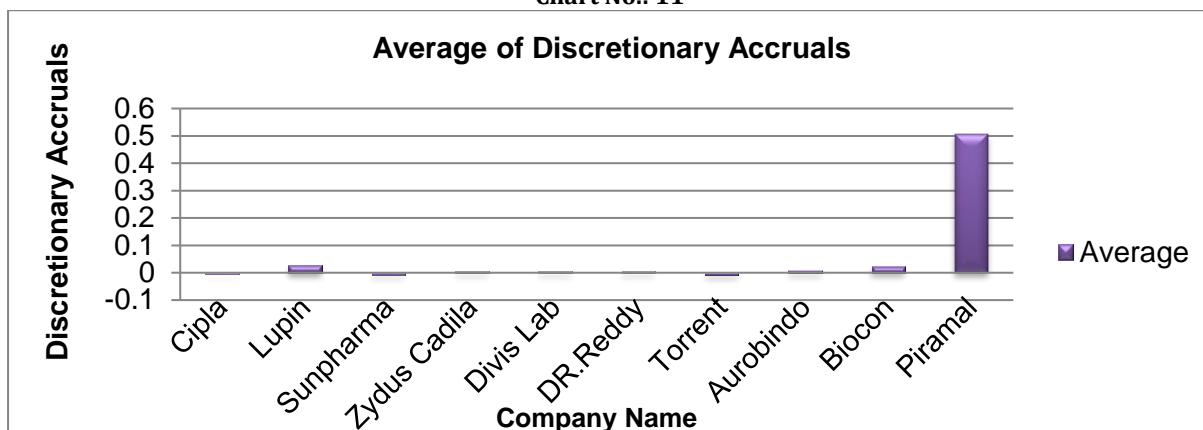


Table No.2 shows the average discretionary accruals of the companies. Discretionary Accruals have been computed using the De Angelo Model. The chart of average discretionary accruals indicates that Cipla Ltd, Sun Pharma Ltd, and Torrent Pharma Ltd has the negative average accruals over the period of study, indicating that managers are making income-decreasing accrual decisions. They are savings for the future. Cipla Ltd, Sun Pharma Ltd, and Torrent Pharma Ltd has highest among all companies. Thus, it is evident that compared to Cipla Ltd, Sun Pharma Ltd, and Torrent Pharma the other companies have low discretionary accruals. This shows that Cipla Ltd, Sun Pharma Ltd, and Torrent Pharma indicate a large amount of fictitious revenue as compared to the other companies. Thus manipulation in the financial statements is high for Cipla Ltd, Sun Pharma Ltd, and Torrent Pharma. Rest of the companies have been found to be exercising income-increasing discretionary accruals, as verified by their positive average. So, it shows a definite presence of accruals management in all the sample companies.

The Earnings management trend predicts a positive discretionary accrual performance in pharmaceutical sector, on an average basis.

FINDINGS

From the analysis of discretionary accruals on the basis of DeAngelo model it is found that the earnings management trend predicts a positive discretionary accrual performance in pharmaceutical sector, on an average basis. Cipla Ltd, Sun Pharma Ltd and Torrent Pharma Ltd are exercising income-decreasing management and they are saving for the future. Thus, manipulation in the financial statements is high for Cipla Ltd, Sun Pharma Ltd, and Torrent Pharma Ltd while rest of the companies exercise income-increasing management.

CONCLUSION

Discretionary accruals act as a proxy to earnings manipulation. This study examines accrual management in the selected pharmaceutical companies in India. Most of the units are found to be exercising income-increasing discretionary accruals, as verified by their positive average. Only Cipla Ltd, Sun Pharma Ltd and Torrent Pharma Ltd are exercising income-decreasing management on an average basis. So, manipulation in financial statement is high for these three companies. The lack of transparency inherent in financial reporting system implies that there is potential to misuse it as a powerful tool of earnings management by the management is high, especially where an organizational choice of discretionary accruals to earnings management exists. Discretionary accrual is least consistent variable with highest coefficient of variation over a period of study.

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