



Corporate Accounting Practices for Decision Making – A Study

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Abstract

The initiatives of SEBI are creditworthy, but it needs to cover more ground. The journey to have a common set of accounting standards started long before to give it a professional shape and essence. And accountants all over the world feel the necessity to shorten the gap among different streams of accounting practices through harmonization. Still, we have a couple of strong variants of accounting practices (say, for example, US GAAP, UK GAAP, IAS etc.) over the world existed and practiced simultaneously. These variants are working as threats towards harmonization of accounting practices. However, the profession has also witnessed some improvements in recent years in the process of global convergence putting some ray of hope. International and even local standard setting bodies have come up with projects of harmonization and in most of the cases became successful. The day is not far away when we will observe that accounting world is controlled and guided by a single set of standards giving it a status of legal discipline in true sense. This study contributes to the existing literature by using the Ohlson (1995) pricing model as a measure to capture earnings management between related parties in Indian firms, but it has a few limitations. India lacks measures of corporate governance, and this study used corporate governance ratings of the top 500 companies as a proxy for corporate governance practices in Indian firms. *Key words International Accounting Standard & Indian Accounting Standard, GAAP*

Introduction

The fundamental work on the relationship between accounting earnings and stock returns (Ball and Brown 1968), and on value relevance (Ohlson 1995), generated interest among researchers in exploring the informational content of accounting information. The focus, initially on markets in the United States, diffused to Canada and Australia (Barth and Clinch 1996) and to Europe—the United Kingdom (Alford et al 1993), France, Germany, and the Netherlands (Harris et al 1994). Researchers have focused on various aspects of earnings management, including earnings management practices by firms during initial public offering (IPO) (Aharony et al 2000), the relationship between value and performance (Arya et al 2003), and developing measures and models to estimate earnings management practices (Kothari et al 2005). Researchers have studied conflicts of interest among controlling and minority stakeholders

(Shleifer and Vishny 1997) and identified control measures to limit the practice of earnings management by emphasising on good corporate governance practices (Gao and Kling 2008; Aharony et al 2010; Sarkar et al 2008).

Asian economies were rapidly integrating with global markets and undergoing structural change, and their inclination towards value relevance in accounting practices was even stronger. The market settings of Asian economies are unique, and their capital markets are evolving fast, and these offer governance practices and reporting standards new challenges. These changing paradigms make it imperative to pay attention to value relevance, as paying attention to value relevance may reduce informational asymmetry and minimise the adverse selection problem of investors (Lundholm and Van Winkle 2006).

Objective:

This paper intends to explore Corporate Governance, accounting practices its harmonization issue, its current status, challenges with special reference to Indian perspective.

Earnings Management, and Corporate Governance in India

In emerging economies, where the shareholding model is promoter-dominated and promoters exercise substantial control, studies provide evidence of principal–principal conflicts (Shleifer and Vishny 1997; Young et al 2008). In India, about 90% of private businesses are family-owned (Merchant 2011), and principal–principal conflicts are the major cause of concern in cases where the majority stakeholding is family-owned, as legal protection for minority stakeholders is weak (Young et al 2008). Related party transactions are used to manipulate earnings (Wong et al 2015), but good governance can restrain “tunnelling,” or the expropriation of the funds and assets of all the shareholders by controlling shareholders (Shan 2013).

Studies have used the Ohlson (1995) price model and the Feltham and Ohlson (1995) price model to investigate the value and relevance of accounting information (Graham and King 2000). Most of these studies ask whether the adoption of new accounting standards increases or decreases value relevance (Aharony et al 2010); whether country-related and institutional factors affect value relevance; or what the relationship is between earnings management, value relevance, and the adoption of International Financial Reporting Standards (IFRS) or IFRS-convergent standards.

Does the adoption of new accounting standards increase value relevance or decrease it (Aharony et al 2010)? In 14 countries in Europe, firms that adopted the IFRS raised investor value (Aharony et al 2010). Conservative accounting practices are less value-relevant in Asian countries, including Indonesia, Malaysia, the Philippines, Taiwan, and Thailand (Graham and King 2000). Domestic investors perceive the Chinese Generally Accepted Accounting Principles as being value-relevant, although the market is young and accounting and financial reporting in China is inadequate (Chen et al 2001).

Do country-related and institutional factors affect value relevance? The internal institutional framework of countries plays a critical role in financial reporting outcomes (Ball et al 2000; Ball and Shivakumar 2005). Ball et al (2000) compare the quality of accounting earnings of countries that follow the Anglo-Saxon model of corporate governance with those of countries that follow the continental model of corporate governance; analysing two essential characteristics of accounting earnings (conservatism and timeliness), they find that timeliness is higher in the Anglo-Saxon governance model. A comparative study of the capital markets of the European Union, Japan, and the United States shows that their institutional and regulatory aspects differ and their accounting information differs significantly in value (Garcia–Ayuso et al 1998).

What is the relationship between earnings management, value relevance, and adoption of IFRS/IFRS-convergent standards? China has mandated that listed firms adopt IFRS-convergent standards, and the quality of earnings reporting has improved (Liu et al 2011). The controlling shareholders use related party transactions to manage earnings, which impacts financial reporting (Ajit et al 2013; Jian and Wong 2010), to inflate earnings and avoid reporting losses (Jian and Wong 2010; Rajagopalan and Zhang 2009). Lo and Wong (2011) study Chinese firms and report a negative association between voluntary disclosures of related party transactions and earnings management.

Holthausen and Watt (2001) review the literature on value relevance and posit that accounting data are informative if there is a relationship with share price or returns. Barth et al (2008) argue that earnings management and value relevance determine the quality of accounting. Good-quality accounting is positively associated with higher value relevance and negatively associated with earnings management, and a negative association is hypothesised, *ceteris paribus*, between earnings management and value relevance (Hypothesis 1).

Tunnelling has been shown to exist by past empirics (Gao and Kling 2008; Friedman et al 2003; Rajagopalan and Zhang 2009). In countries like India, where ownership is concentrated and the governance structure is weak, controlling stakeholders may practise earnings management by tunnelling (Ajit et al 2013). Chinese firms use related party transactions to misappropriate the assets of minority shareholders (Cheung et al 2009).

An IPO is a transition in the market, and it may incentivise earnings management before the listing; and tunnelling may be practised in the post-IPO period. Chinese firms practise tunnelling during the IPO process and to exploit economic resources at the expense of the minority shareholders, who are part of the IPO process, to benefit the parent company (Aharony et al 2010). Related party lending transfers significant amounts of cash from listed firms to controlling owners.

In emerging economies, earnings management practices pose a severe challenge. Good governance reduces the practice of earnings management (Buniamin et al 2012), and legal and regulatory reforms are needed to curb insider abuse and safeguard the minority interest (Jiang et al 2010; Rajagopalan and Zhang 2009).

One of the distinguishing characteristics of a modern corporation is the dichotomy of ownership and control (Berle and Means 1932); owners rarely participate in day-to-day activities. Agents may act in their interests against the owners' and lead a firm to practise earnings management—the “agency problem.” Enforceable contracts protect owners from such conflicts of interest, but these give rise to “agency cost” (Jensen and Meckling 1976). Such conflicts of interest motivate many corporate governance studies that analyse how corporate governance can mitigate the agency problem and agency cost (Shleifer and Vishny 1997). Some of these studies corroborate that better corporate governance

mechanisms reduce the practice of earnings management in companies (Sarkar et al 2008; Shan 2015). It is hypothesised that, ceteris paribus, good corporate governance mechanisms are negatively associated with earnings management (Hypothesis 2).

In attempting to understand the domino effect in terms of value relevance, earnings management, and corporate governance in India, this paper addresses two key research questions: Does the practice of earnings management affect value relevance? Do corporate governance practices limit the earnings management practice of Indian firms? In this study, earnings management is operationalised through related party transactions, which may be both normal and abnormal. Lo and Wong (2011) report incentives for using abnormal related party transactions (ARPT) for managing earnings, following the Jian and Wong (2010) model, and this study uses ARPT as a proxy for earnings management.

Data

This study uses the data for a five-year period (from 2012 to 2016) for all companies that are part of the broad-based NIFTY 500 index, which is created and maintained by the National Stock Exchange (NSE). This study extracted the corporate governance ratings from the *Bloomberg* database for these 500 companies and the data source for related party transactions from the Capitaline database. The remaining financial data are obtained from the Prowess database of the Centre for Monitoring Indian Economy. The stock prices and trade volume proxy for stock liquidity are sourced from the website of the NSE. Banks, financial service companies, and state-owned enterprises (public service undertakings) are exempt from disclosing related party transactions, and this study excludes these institutions.

Conclusion

Accounting information is relevant to the stock prices of listed companies in India, and improving the reporting standards of accounting information would raise investor confidence in the authenticity of the reported and published financial statements. Good corporate governance practices can limit earnings management in Indian firms. Policymakers and regulators can use these findings as signals to undertake reforms or policy initiatives in governance practices, and they can promulgate improved standards of codes and guidelines on governance practices concerning related party transactions to moderate the earnings management practices of Indian firms.

Auditors play a role in cases of earnings management; they are legally obligated to reporting wrongdoings. However, corporate scandals like Satyam Computer Services were a result of the collusion of promoters and auditors. The SEBI levied a penalty on PricewaterhouseCoopers, the auditors, and banned them from their audit practice for two years, but such cases point towards the systemic problem in the audit process. Are we waiting for a second Satyam in the making? However, SEBI seems to be sending the message that governance practices need to be time-variant to accommodate the changing dynamism in the corporate sector strongly.

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