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Corporate Governance and Creative Accounting Practices - A Dichotomy

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ABSTRACT

According to agency theory 'the firm is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations.' Within the agency framework, it is both logical and inescapable that management behaviour will be self-serving. Agency can, therefore, provide a solid framework for the understanding of creative accounting behaviour. The informational perspective is a key element underpinning the study of the creative accounting phenomenon. A conflict is created by the information asymmetry that exists in complex corporate structures between a privileged management and a more remote body of stakeholders. Managers may choose to exploit their privileged position for private gain, by managing financial reporting disclosures in their own favour. The informational perspective assumes that accounting disclosures have an information content that possesses value to stakeholders in providing useful signals. It may be difficult or impossible for individual stakeholders to discern the fact and the effect of accounting manipulation, because of an insufficient personal skill set, indifference or an unwillingness to engage in detailed analysis.

Corporate governance encompasses all the provisions and mechanisms that guarantee the assets of the firm to be managed efficiently and in the interests of the providers of finance, mitigating the inappropriate utilization of resources by managers or any other party to the firm. Financial reporting is the primary medium of communicating the workings and results of the operations of the company to its stakeholders. Use of creative accounting negatively affects the usefulness of financial reporting and ultimately affects the spirit of corporate governance. The study has been undertaken with the broad objective of determining the existence of creative accounting among the companies selected for the study and also to find an association in between Agency Theory of corporate governance and creative accounting. The study covers the companies listed in the NSE.

KEYWORDS : Creative Accounting, Corporate Governance, NSE, Stakeholders

Corporate Governance and Creative Accounting Practices - A Dichotomy

This research paper aims to provide academic evidence on creative accounting and possible association between the Agency Theory of corporate governance and creative accounting.

The present paper has been structured around five sections as discussed below:

Section I: The section I of the paper gives a brief introduction of the study.
Section II: The section II of the paper explains regarding Agency Theory of Corporate Governance.
Section III: Section III of the paper gives an overview of Creative Accounting and Income Smoothing.
Section IV: Section IV of the paper details out the methodology of the paper and give evidence on the existence of Creative Accounting with the help of an empirical research carried out by the present researchers.
Section V: Section V of the paper gives an overall conclusion.

Section I

Prologue: According to agency theory 'the firm is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations.' Within the agency framework, it is both logical and inescapable that management behaviour will be self-serving. Agency can, therefore, provide a solid framework for the understanding of creative accounting behaviour. The informational perspective is a key element underpinning the study of the creative accounting phenomenon. A conflict is created by the information asymmetry that exists in complex corporate structures between a privileged management and a more remote body of stakeholders. Managers may choose to exploit their privileged position for private gain, by managing financial reporting disclosures in their own favour. The informational perspective assumes that accounting disclosures have an information content that possesses value to stakeholders in providing useful signals. It may be difficult or impossible for individual stakeholders to discern the fact and the effect of accounting manipulation, because of an insufficient personal skill set, indifference or an unwillingness to engage in detailed analysis.

Section II

Agency Theory of Corporate Governance: Agency theory suggests that the firm can be viewed as a nexus of contracts (loosely defined) between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents. The primary agency relationships in business are those (1) between stockholders and managers and (2) between debt holders and stockholders. These relationships are not necessarily harmonious; indeed, agency theory is concerned with so-called agency conflicts, or conflicts of interest between agents and principals. This has implications for, among other things, Corporate Governance and business ethics. When agency occurs it also tends to give rise to agency costs, which are expenses incurred in order to sustain an effective agency relationship (e.g., offering management performance bonuses to encourage managers to act in the shareholders' interests). Accordingly, agency theory has emerged as a dominant model in the financial economics literature, and is widely discussed in business ethics texts.[1]

Section III

Creative Accounting:

Creative accounting is the science and art of making the accounts look attractive within the existing parameters of performance. In essence, creative accounting makes for a half-filled glass of water look like half-full rather than half empty.[2]

The term 'creative accounting' can be defined in a number of ways. Initially we will offer this definition: 'a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business'[3]

Griffiths as a business journalist writing from perspective of a business journalist, observes: "Every company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures which

are fed twice a year to the investing public have all been changed in order to protect the guilty. It is the biggest con trick since the Trojan Horse………..In fact this deception is all in perfectly good taste. It is totally legitimate. It is creative accounting." [4]

Concept of Income/Profit Smoothing:
Beidleman (1973) defined income-smoothing as an attempt on the part of the firm's management to reduce abnormal variations in earnings to the extent allowed under sound accounting and management principles. Koch(1981) defined income smoothing as a means used by the management to diminish the variability stream of reported income numbers relative to some perceived target stream by manipulation of artificial (accounting) or real (transactional) variables[5] .

Section IV
RESEARCH METHODOLOGY:
Rationale of the Study
From the preceding sections it transpire that the Agency Theory Corporate governance and creative accounting defy each other and dichotomous in nature. In one hand, Agency Theory of corporate governance requires the company to be ethical and transparent in its conduct. On the other hand, creative accounting leads to the concealment of actual financial result of the company and therefore Agency Theory of corporate governance and creative accounting are standing on the two dichotomous ends. Taking this as rationale of the study, effort has been made to add to the existing stock of knowledge.

Objectives: the Study:
The present study has been undertaken taking into mind the following broad objectives-

i. To determine the presence of Creative Accounting among the companies selected for the study
ii. To associate the existence of Creative Accounting with the Agency Theory Corporate Governance.

Hypothesis: The following research hypotheses have been framed for the present paper:

- Smoothing practice is not prevalent among the listed companies in India.
- Agency Theory of Corporate Governance does not get affected due to use of Creative Accounting techniques in financial reporting

Size of the Population: During the tenure of the research study, the number of listed companies in the NSE as on 31st July 2014 has been 1652. In statistics, a population is a complete set of items that share at least one property in common that is the subject of a statistical analysis. However for the present study total population has been taken as the companies included in CNX Nifty because **criteria for selection of constituent stocks are common for all the stocks viz Liquidity (Impact Cost), Floating Stock etc.** The population consists of 50 companies and out of these 50 companies; finance sector companies have been excluded. The finance sector companies have been excluded from the study because of its unique characteristics of financial reporting practice. The number of companies included in CNX Nifty after excluding finance sector companies stands at 40. This has been taken as the population for the present study.

Size of the Sample: It has been decided on the basis of Cochran's model of sample determination. The sample has been fixed at 30 which have been decided on the basis Cochran's sample determination literature. Judgmental sampling technique has been used for drawing these 30 companies from the population of 40 companies. The sample size of 30 is 75% of total population of 40 and this 75% has been taken as the criterion to select sample companies proportionately from private and public sector. Accordingly, out of total 32 private sector companies, 24 (75% of 32) has been taken as the sample companies. Similarly, out of total 8 public sector companies, 6 (75% of 8) has been taken as the sample companies.

The Method of Data Collection adopted has been selected keeping in view the nature, scope and object of the present study. Primary data in the form of published Annual reports of the companies have been collected by post, fax and internet. Data has been collected for a period of 10 years i.e. 2003-2004 to 2012-2013.

Measuring income smoothing
In this research study, the procedure employed to determine the presence of Income Smoothing is the coefficient of variation method developed by Eckel (1981). Eckel's method measures smoothing by aggregating the effects of potential smoothing variables and considering over time (Ashari et al 1994).This aggregation of variables is important, as Zmijeaski and Hangerman (1981) suggest that companies select accounting procedures, not independently, but based upon their overall expected effects on income.

$$CV_{\Delta I} \geq CV_{\Delta S}$$

where ΔI=One period change in income

ΔS=One period change in sales

CV=Coefficient of variation

$$CV = \frac{\text{Standard Deviation}}{\text{Mean}}\left(\frac{\sigma}{a}\right)$$

The actual objectives of income-smoothing with respect to the income statement have been interpreted in various ways. Some studies (e.g. Copeland 1968) suggest net income as the ultimate aim of smoothing. Ronen and Sadan (1975, 1981) propose that the object of smoothing is ordinary income. Imhoff's (1981) possible measures of income-smoothing include net income, operating income[7]. In the present study, the objective of income-smoothing has been taken as PBT

The present study modified the original Eckel's model and assumes a company as non-smoother if

$$CV_{\Delta I} = CV_{\Delta S}$$

logic behind this assumption is that if the income figure and sales figure of a company are taken over a period of time, then, the Coefficient of Variation of income i.e. the variation of change in income and the Coefficient of Variation of sales i.e. the variation of change in sales should be same. So the company where the $CV_{\Delta I} > CV_{\Delta S}$ or $CV_{\Delta I} < CV_{\Delta S}$, it will be considered as a smoother company.

In the present study, a company is considered as a non-smoother even if-

$$CV_{\Delta I} \approx CV_{\Delta S} \text{ i.e. } \frac{CV_{\Delta I}}{CV_{\Delta S}} \approx 1$$

In the study, the ratio of CV of PBT to CV of sales is used as Eckel's Index (Income-Smoothing Detector) to identify the sample of the company's as smoother and non-smoother.

Findings of the Study:
Descriptive Statistics
Eckel's Index has been calculated as an indicator of income smoothing practice using ratio of Profit before Tax and sales. Out of the total 30 sample companies only 3 (10%) companies are found to be non-smoother as in case of these 3(10%) companies, the Eckel's Index is approximately equal to 1. At the same time, out of the 30 companies, 27(90%) are found to be smoother as Eckel's Index for these companies are either greater than 1 or equal to 1.

Inference on Research Hypotheses:

Smoothing practice is not prevalent among the listed companies in India.

The first hypothesis of the study deals with the question of whether creative accounting in the form of income smoothing is prevalent among the listed companies in India. However, from the descriptive statistics, it has been found that 27(90%) companies are involved in income smoothing activity whereas only 3(10%) companies are proved to be non-smoothers. Many previous studies proved the presence of income smoothing among the companies. But for this paper, the study undertaken by Kamarudin *et al* among the companies listed in the Kuala Lumpur Stock Exchange has been used as benchmark for comparison. The findings of the study showed that the number of smoothing firms was smaller compared to non-smoothing firms where 81(71%) firms are classified as non-smoother and 33(29%) firms as smoother. The study concluded that smoothing is present among the companies but at a lower level. Since the percentage of smoother companies in the present study has been much higher as compared to the study undertaken by Kamarudin *et al* among the companies listed in the Kuala Lumpur Stock Exchange, it can be concluded that smoothing is prevalent among the listed companies in India at a higher level. Therefore, the null hypothesis can be rejected.

H_{02}: Agency Theory of Corporate Governance does not get affected due to use of Creative Accounting techniques in financial reporting.

The second hypothesis deals with the question of whether Agency Theory of Corporate Governance gets affected due to use of Creative Accounting techniques in financial reporting. The view taken by the Agency Theory of Corporate Governance on the directors is that they cannot be trusted to act in the public welfare in general and in the interest of the shareholders in particular. In fact, they need to be monitored and controlled to ensure compliance. Therefore, the core concept of Agency Theory of Corporate Governance is to ensure the fulfillment of the responsibility and accountability of the companies towards the investors in particular. Moreover, companies are required to be transparent and ethical in its conduct as per the theories Corporate Governance. Corporate Governance encompasses all the provisions and mechanisms that guarantee the assets of the firm to be managed efficiently and in the interests of the providers of finance, mitigating the inappropriate utilization of resources by managers or any other party to the firm. Financial reporting is the primary medium of communicating the workings and results of the operations of the company to its stakeholders. On the other hand, Creative Accounting tends to hide the actual financial result of the company. This manipulated financial result will have effect on the decisions of the investors. Sometimes, companies indulge in creative accounting in order to avoid taxation and donation. These all lead to the denying of Agency Theory of Corporate Governance on the part of the company. Creative Accounting has been an accepted term in the accounting parlour. In this research work, it has been observed that Creative Accounting has been practiced in the Indian listed companies and if Creative Accounting exists, the Agency Theory of Corporate Governance become futile at the grassroot level and Corporate Governance can't be achieved in real sense. Therefore, the null hypothesis can be rejected and concluded that Agency Theory Corporate Governance does get affected due to use of Creative Accounting techniques in financial reporting.

Section V:

Epilogue: The Agency Theory of Corporate Governance and the use of Creative Accounting techniques in financial reporting seem to be dichotomous in nature. The Agency Theory propagates that the financial reporting should be for the best interest of the investors but it is not always a reality. The present researchers have established by way of their research findings that a substantial portion of companies listed with the NSE are smoothing(either they are overstating or understating certain pivotal accounting numbers) which is inter alia against the principles of the Agency Theory of Corporate Governance. It is worth mentioning here that sometimes the company management reluctantly willing to use the Creative Accounting path. The use of Creative Accounting also increases the Agency cost for resolving the agency problems.

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