

## Market Efficiency and Creative Accounting- Some Issues



## Commerce

**KEYWORDS :** Creative accounting, Market efficiency, Stock prices, Information, NSE.

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### ABSTRACT

*Accounting is a process which guides a business organization to run its activity in a safer direction. User groups being too many, and for that matter the financial reporting process of companies have been frequently facing the hurdle of satisfying different such user groups with their diversified needs. Satisfying the desires of share holders regarding high profits, dividends may bring in problems of high taxes, demand for higher wages and bonus etc. On the other hand lower profit trend may have a negative image in the minds of the investors regarding investment choice. Therefore, this requires the accountant to maintain a balance in between according to the needs of the situation. To do this accountant relies on the techniques of creative accounting.*

*Existence of creative accounting has raised many questions regarding the efficiency of market. Concept of market efficiency requires the stock prices to reflect all the relevant information for the investors and financial reports are the most important information medium of a company among all. On the other hand, creative accounting leads to the concealment of actual financial result of the company and therefore both the concept of market efficiency and creative accounting are standing on the two dichotomous ends. This has been taken as the rationale of the present study. 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 creative accounting and market efficiency. The study covers the companies listed in the NSE.*

**Prologue:** Accounting is a process which guides a business organization to run its activity in a safer direction. User groups being too many, and for that matter the financial reporting process of companies have been frequently facing the hurdle of satisfying different such user groups with their diversified needs. Satisfying the desires of share holders regarding high profits, dividends may bring in problems of high taxes, demand for higher wages and bonus etc<sup>1</sup>. On the other hand lower profit trend may have a negative image in the minds of the investors regarding investment choice. Therefore, this requires the accountant to maintain a balance in between according to the needs of the situation. To do this accountant relies on the techniques of creative accounting.

**Market Efficiency:** The efficient market hypothesis (EMH) was first introduced by Roberts (1967) and states that in an information efficient market, the stock prices of companies will reflect all relevant available information for that company. This hypothesis implies that if the stock prices of companies reflect all relevant available information, financial resources will efficiently be allocated. In addition, the hypothesis implies that as soon as new relevant information becomes available, this will directly be incorporated in the stock price. Consequently, the quicker the new information is reflected by the stock prices, the more efficient a market tends to be. In 1970, Fama introduced a new approach to the EMH. He recognized three forms of information efficient markets. These are:

1. The weak form of EMH.
2. The semi strong form of EMH.
3. The strong form of EMH.

**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<sup>2</sup>.

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'<sup>3</sup>.

### Concept of Income/Profit Smoothing:

The term-income smoothing refers to a kind of Income management that reflects economic results according to the management wish. Accordingly, the income does not portray the real economic performance of the business entity for the period. Income smoothing not only relies on falsehoods and distortion but on the various alternatives available in accepted accounting principles. It is conducted within the structure of Generally Accepted Accounting Principles (GAAP). The prime objective of Income-smoothing is to moderate income variability over the years by shifting income from good years to bad years<sup>4</sup>.

Income smoothing is defined as a deliberate dampening of fluctuations about some level of earnings considered to be normal for the firm – Barnea *et al.* (1976)<sup>5</sup>.

### Objectives: the Study:

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

- To determine the presence of Creative Accounting among the companies selected for the study
- To associate the existence of creative accounting with the market efficiency.

**Hypothesis:** The following null hypotheses have been framed for the present study:

H<sub>01</sub>: Smoothing practice is not prevalent among the listed companies in India.

H<sub>02</sub>: Market Efficiency does not get affected due to use of Creative Accounting techniques in financial reporting

### RESEARCH METHODOLOGY:

**Size of the Population:** During the tenure of the research study, the number of listed companies in the NSE as on 31<sup>st</sup> 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).

As per the model, a firm is not classified as an income smoother if<sup>6</sup>

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

where  $\Delta I$ =One period change in income

$\Delta S$ =One period change in sales

CV=Coefficient of variation

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

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

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:

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:

#### H<sub>01</sub>: Smoothing practice is not prevalent among the listed companies in India has been rejected.

The second hypothesis deals with the question of whether Market Efficiency gets affected due to use of Creative Accounting techniques in financial reporting. The concept of market efficiency expresses the fact that the quoted market prices faithfully reflect the underlying economic reality, and so enable the investors or asset managers to make a reliable decision (buy or sell), meaning with full knowledge of the relevant facts necessary for this decision. If the relevant information necessary for a transaction is correctly transmitted in the price, and considered as an exchange mechanism, the market is then called efficient. Creative accounting in any form is the technique of hiding the economic reality of the business. Market Efficiency means the complete reflection of all the published and unpublished information of the company into the stock prices. 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. The perception of the investors regarding a company has a direct effect on the stock prices. Thus the stock prices do not result from the actual financial information of the company. As a result, market efficiency gets affected by the creative accounting. Creative accounting has been an accepted term in the accounting fraternity. In this research work, it has been observed that creative accounting has been practiced in the Indian listed companies and if creative accounting exists, market efficiency can't be achieved in real sense. Therefore, the null hypothesis:

#### H<sub>02</sub>: Market Efficiency does not get affected due to use of Creative Accounting techniques in financial reporting has been rejected.

**Epilogue:** The study was undertaken with a broad objective of determining the presence of creative accounting practice among the sample companies and associating this result with the existence of the market efficiency. The result of the study gives an idea regarding the presence of creative accounting practice among majority of sample companies. The purpose of the study has been fulfilled as creative accounting practice has been found in the sample companies and association has also been found in between creative accounting practice and market efficiency. Creative accounting is a highly unethical practice which has been found to be exercised by majority of the corporate houses. The accounting system recognized in India and abroad has not allowed such practice while finalizing financial statements of a business enterprise. But in spite of that some business houses are inclining to adopt creative accounting practice to a certain degree. It is observed that a very small degree of creative ac-

counting practice may not be harmful for investors and at the same time the image of the enterprise keeps in high position. But, high degree of creative accounting practice is betrayal to the investors and the customers.

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