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## Управління прибутком на підприємствах автомобільного сектора Індії: огляд корпоративного управління

Еволюція корпоративного управління в Індії та в усьому світі загалом обумовлена постійним розвитком практики корпоративного управління. Стаття присвячена аналізу практики управління прибутком в різноманітних автокорпораціях Індії. Автомобільному сектору Індії характерна швидка диверсифікація з погляду асортименту продукції та ринків, а тому актуальним є питання корпоративного управління, зокрема в сфері розподілу прибутку автокорпорацій. Управління прибутком оцінюється і корелює з параметрами якості прибутку і загальних доходів. Результати проведеного дослідження показують, що в зразкових компаніях здійснюється управління нароцтванням прибутку, а тому це покращує довіру інвесторів до компаній та підвищує зацікавленість у їхній діяльності.

**Ключові слова:** Управління прибутком, нарахування, якість, диверсифікація, корпоративне управління.

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## Управление прибылью на предприятиях автомобильного сектора Индии: обзор корпоративного управления

Эволюция корпоративного управления в Индии и во всем мире в целом обусловлена постоянным развитием практики корпоративного управления. Статья посвящена анализу практики управления прибылью в различных автокорпорациях Индии. Автомобильному сектору Индии характерна быстрая диверсификация с точки зрения ассортимента продукции и рынков, а поэтому актуален вопрос корпоративного управления, в частности в сфере распределения прибыли автокорпораций. Управление прибылью оценивается и коррелирует с параметрами качества прибыли и общих доходов. Результаты проведенного исследования показывают, что в образцовых компаниях осуществляется управление наращиванием прибыли, это улучшает доверие инвесторов к компаниям и повышает заинтересованность в их деятельности.

**Ключевые слова:** управление прибылью, наращивание прибыли, качество, диверсификация, корпоративное управление.

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## Earnings Management in Auto Sector Enterprises in India: The Corporate Governance Review

The evolution of corporate governance in India and globally is attributed to the manipulative practices by the corporate. The present paper analyzes the earnings management practices in diversified auto corporate enterprises in India. Indian auto sector has rapidly diversified in terms of its product range and the markets and therefore attracts issue of corporate governance on account of earnings management. Earnings management is evaluated and correlated on quality parameters of earnings and revenue. The results indicate accrual management in the sample companies and it is hoped the study improves investors' belief of a company's performance.

**Keywords:** Earnings management, accruals, quality, diversification, corporate governance.

## 1. THE PROBLEM

**Earnings Management**

Earnings management is an area of common interest to academia, regulators and practitioners. Earnings management is exercised in the name of accounting flexibility but their misuse has far reaching effects, destroying shareholders' value. The subject under research is relevant not only for the business community but also for the public at large.

In the present study, we focus our attention to earnings management practices in Indian diversified auto sector enterprises with focus on corporate governance. The present study contributes to the literature by increasing the understanding about earnings management behaviour of managers in regard to the corporate governance in the diversified Indian auto sector.

(Healy and Wahlen, 1999) state, '*Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers*'.

(Goel, 2012) in his study evaluates the implications of discretionary accruals for earnings management in the Indian corporate enterprises. His analysis indicates that there is presence of accrual management in the units.

**Corporate Governance**

Indian Companies Act, 2013 has given an added dimension to Corporate Governance with emphasizing on Board's efficiency and effectiveness. The reason being is that earnings manipulation and mis-governance are dictated by them. Recent high-profile corporate failures of Kingfisher and Sahara document the fact. Therefore, corporate performance and accountability becomes very crucial in the light of these emerging manipulative practices. Corporate governance is basically a system for ensuring transparent corporate management in a right and fair manner.

(Cadbury Committee, 1992) define *Corporate governance* as 'the system by which companies are directed and controlled'.

(OECD, 1999) define *Corporate governance* as 'the structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective'.

Corporate governance in India started with *clause 49 of the listing agreement of SEBI* on the recommendations of the Birla committee and Narayana Murthy committee report. Clause 49 of the listing agreement to the Indian stock exchange came into effect from 31 December 2005, for improving corporate governance in all listed companies<sup>1</sup>.

<sup>1</sup> Cited from Goel Sandeep, Corporate Governance in the Changing Economic Scenario: The Indian Regulatory Picture, Conference Proceedings (8th February, 2014): Financial Markets in Changing Economic Scenario, <http://www.sebi.gov.in/commreport/clause49.html> Accessed on 24th April, 2014.

**Corporate Governance and Earnings Management**

Earnings management is always seen as a linkage to corporate governance because corporate governance evolved as an outcome of earnings management behaviour of the management. Corporate governance refers to the way the company is managed and it is primarily directed towards shareholders. Earnings management is the discretionary behaviour by the management for manipulating earnings, resulting in erosion of shareholders' value. Corporate governance will always continue to be an area of importance on account of earnings management practices by the corporate. **Therefore, the present study evaluates earnings management practices of auto sector in India and thereby highlights the need for corporate governance.**

**Indian Auto Sector**

The Indian auto components industry has witnessed an exponential growth over the last couple of years. Its recovery since 2008 could be attributed to factors such as stimulus from the end-user industry; recovery of the global economy; and improved liquidity in the financial system.

(Ghosh, Ray, and Makkar, 2010) states that the sector is a real diversified sector as it consists of automobile segments, comprising two-wheelers (2W), three-wheelers (3W), passenger vehicles (PVs) and commercial vehicles (CVs) Every second day there is a new model launch by the companies for the customers across the country. Indian companies have diversified to achieve global scale rapidly; make entry into new markets; acquire new customers and gain access to new technology.

**2. LITERATURE REVIEW****Earnings management**

Earnings management is the practice of using tricks in order to misrepresent/ reduce transparency of the financial reports (Schipper, 1989; Levitt, 1998; Healey et al., 1999).

(Burgstahler, and Dichev, 1997) provide systematic evidence that firms increase reported earnings to achieve various incentives. They can range from capital market motivations to contractual motivations to management compensation. (DeAngelo, 1988) reports that earnings information is important for valuations in management buyouts and therefore managers of buyout firms have an incentive to 'understate' earnings. (Burgstahler, and Eames, 1998) find that firms manage earnings to meet analysts' forecasts. (Watts and Zimmerman, 1978) suggested that contracts provide incentives for earnings management.

Firms with limits on bonus awards intend to report accruals for deferring income as compared to firms that have comparable performance but do not have a limit on bonus (Healy 1985; Holthausen, Larcker, and Sloan, 1995).

A fundamental element of any test for earnings management is a measure of management's discretion over earnings. The literature has followed several approaches, with varying characteristics. First, there is a large literature that attempts to identify discretionary

accruals based on the relation between total accruals and hypothesized explanatory factors. This literature began with (Healy, 1985) and (DeAngelo, 1986), who used total accruals and change in total accruals, respectively, as measures of management's discretion over earnings. (Jones, 1991) introduced a regression approach to control for nondiscretionary factors influencing accruals, specifying a linear relation between total accruals and change in sales and property, plant and equipment.

(Beneish, 2001) discussed the analytics for income-increasing earnings management, income-decreasing earnings management and specific contexts, e.g. financial institutions with regulatory constraints.

There is little theoretical literature on earnings quality measures. (Ewert and Wagenhofer, 2011) model earnings quality in a rational expectations capital market equilibrium, and allow for private information by management and earnings management. They examine persistence, predictability, smoothness, discretionary accruals and value relevance.

Identifying earnings management is one of main challenges for both researchers and practitioners (Dechow, Hutton, Kim, and Sloan 2012). One widely used method is to isolate discretionary and non-discretionary accruals as a good earnings management detection model.

Goel (2014) analyzed earnings management behaviour of telecom sector in India using quality testing. Their quality score well signalled earnings management.

#### **Corporate Governance**

Corporate governance is a set of mechanisms by which outside investors protect themselves against expropriation by insiders (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 2002). Corporate governance concerns the exercise of power to direct and control companies (Clarke, 2004).

The international focus on corporate governance systems and practices has increased since the global meltdown. In response, many governments made incremental changes to their financial markets' corporate governance requirements (OECD, 2009). Though there are a large number of studies on different aspects of corporate governance in developed markets (Jensen and Meckling, 1976; Jensen, 1993; Gompers, Ishii, and Metrick, 2003; Lawrence and Marcus, 2006) studies of corporate governance in emerging markets are few in number. So, the review of corporate governance practices in emerging markets is necessary because of the different nature of their social, cultural, and economic factors. Poor corporate governance is considered as one of the main causes of the Asian economic crisis (Nam and Nam, 2004).

(OECD, 2004) advocates that companies should continuously pursue good corporate governance practices for a more efficient resource allocation and high growth.

Corporate governance has significant implications for the financial stability and performance of companies and the resulting economic growth of a country (Rezaee, 2009).

#### **Earnings Management and Corporate Governance**

Earnings management is an outcome of Agency conflict, whereas Agency theory states that managers

(agents) should always act in the best interest of the principal (shareholders). But in practice, it is other way round. Managers are focused on self-interest rather than on the interests of the owners. This is where problems of corporate governance emerge due to earnings management behaviour by the management. (Jensen and Meckling, 1976) define this relationship as a contract under which the principal employs the agent with an expectation that they will act and make decisions in their best interests. But, due to opportunistic behaviour, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2002).

So, the managers might pursue their self-interests to maximize their own wealth at the cost of other parties' interests (Jensen, 1986). Furthermore, contracts between managers and financial providers may require the managers to disclose accounting information for effective supervision by the financial providers. However, this information is provided by the managers (Watts and Zimmerman, 1986), who may choose to overstate the financial numbers through their accounting estimates and standards.

The implication of this review is that the earnings management area remains a fertile ground for academic research in the context of corporate governance. The present study aims to fill the void by analyzing earnings management practices in Indian diversified auto sector for corporate governance.

#### **Gap Areas**

Earnings management is an important accounting issue for academics and practitioners alike. The present study identifies earnings management in Indian diversified auto sector, *particularly for corporate governance*. There are various models existing in the literature to detect these manipulative corporate practices, primarily devised keeping in view the developed nations. There is remarkably little evidence on earnings management using quality aspect of earnings and revenue, suggesting that this is likely to be a fruitful area for future research.

So, the survey of the existing literature indicates that so far no specific work has been carried out on earnings management in diversified corporate enterprises in India, using the aforementioned models, although the importance of such a study cannot be underestimated.

#### **Contribution of the Study**

The present study contributes by filling the aforementioned gap areas. This study is one of its own kinds on two grounds:

- i. taking an Indian perspective; and
- ii. highlighting the role of quality tools in testing earnings behavior.

#### **3. OBJECTIVE OF THE STUDY**

The main aim of the study is to review and analyze the earnings management practices of auto enterprises in India for corporate governance. The study specifically aims at the following:

§ To test quality of earnings and quality of revenue of the units under study for indicative earnings manipulation.

§ To highlight the major areas of concern in earnings manipulations in these undertakings for their corporate governance.

The study analyzes earnings management practices in the Indian auto sector, an area untouched so far. The quality aspect of earnings and revenue has been tested to highlight how the financial statement frauds are increasing and destructing shareholders' value. This is an indicative of poor corporate governance.

#### **4. RESEARCH METHODOLOGY**

##### **Sample**

The present study covers the listed companies in diversified Indian auto sector. Keeping in view the differences in the objectives and functions of these companies, the present research would concentrate on only the companies in the private sector. The enterprises have been chosen on the basis of their diversified portfolio to have an equal representation of different types of enterprises operating in the Indian auto sector. Companies like Hero MotoCorp, Bajaj Auto and TVS are two wheeler manufacturers. Companies of Maruti Suzuki, Tata Motors and Mahindra and Mahindra are Passenger car/utility manufacturers. Ashok Leyland, Force Motors and Eicher Motors are Commercial Vehicle manufacturers. Sundaram Clayton is an automotive parts manufacturing company. A list of these companies appears in Appendix I.

##### **Period of the study**

The period covered in the present research study is of three years, ranging from 2008-09 to 2010-11. It has been taken as it was reasonably a good period to analyze the expected impact of the market conditions on increasing firms' incentive to manage earnings, post recession.

##### **Data used**

For the purpose of the present study, the main data used is secondary in nature, keeping in view the nature of the study. The study employs both accounting and market data. The accounting data has been obtained from the annual reports of the companies and market data has been obtained from BSE's website.

##### **Tools / techniques used**

Various earnings management tools, developed specifically for detecting earnings management, have been used in the present study. (Goel, 2014) has highlighted the poor quality score of corporate enterprises in India for earnings management. Those models have been extended in the present study. They include the following:

##### *Quality of Earnings model*

Quality of earnings is computed as the percentage of operating cash flows to net income of a firm. Higher the quality of earnings, lower the chances of earnings manipulation.

##### *Quality of Revenue model*

Quality of revenue is computed as the percentage of collection of sales in cash. Higher the quality, lower the chances of earnings manipulation.

The data analysis has been well supported by various accounting and statistical techniques, including trend analysis, bar charts, and graphs (time series). 'Correlation analysis' has been applied to find out the level of

interrelationship between earnings management detection tools.

## **5. RESULTS AND DISCUSSION**

### **A. Earnings management detection**

Following is the discussion of the analytical results of the sample companies of earnings management detection for corporate governance, depicted in figures 1-10.

#### *1. Quality of Earnings*

Quality of earnings of Tata Motors is quite good, compared to the other players in the industry, though it does dip below 100 % in 2010-11, but otherwise the operating cash flow is almost thrice the Net Income. Mahindra & Mahindra show largely a steady earnings quality as compared to other firms, even though it dips below 100 % for the last year. However, the constant range-bound quality of earnings figure shows that its operating cash flows are quite steady in comparison to net income, which is a good sign for the company.

The quality of earnings of Maruti Suzuki has been moderately volatile, but steadily increasing over the last 3 years. The assuring factor is that it has always been above 100 % for all the years, which shows a robust percentage of their income being reflected in the operating cash flows. The quality of earnings for Hero MotoCorp has been very steady, despite the demerger with Honda. The value has been declining in minor degrees, but has been close to 100 % consistently, which is a positive indicator of the earnings quality.

The quality of earnings for Bajaj Auto is very worrying as it dipped below 100 % to a value close to 50 % in 2010-11, before recovering in the subsequent year. This is not a healthy sign for the company because it shows that the net income is not impacting the operating cash flows, and is hence a suspect case. The earnings quality of Ashok Leyland has been consistently above 100 % which shows a healthy trend for the company, even though its value has fluctuated greatly, ranging from 250 % to 100 %, and then up again to 200 % in a gap of just 3 years.

The quality of earnings for Sundaram Clayton has been abnormally high and fluctuating for the last 3 years, with the value reaching 800 % in 2010-11, and falling to close to 150 % in the next year. This has been primarily due to large investments made by the company in non-operating activities, which show up in the quality of earnings. TVS Motors's earnings quality has been again fluctuating greatly across the 3 years studied, with the value starting at 400 % in 2009-10, falling to 100 % in 2010-11, and again climbing to 200 % in 2011-12. Such large fluctuations should be avoided, although the fact that the value stays above 100 % for all the years is commendable.

The quality of earnings of Eicher Motors is extremely low by any standards, as it has been below 100 % for 3 consecutive years. This raises questions about the company's net income, and why the growth in the net income is not translating to subsequent growth in the operating cash flows. The quality of earnings for Force Motors is disappointing in the last year, as the

operating cash flows dipped to negative values, leading to a negative value of quality of earnings.

**2. Quality of Revenues**

Tata Motors' revenue quality also sees a corresponding dip towards a negative value in 2010-11, and stays less than 100 even for year 2011-12. This shows the percentage of revenue in terms of cash collected from debtors is decreasing. The quality of revenue of Mahindra & Mahindra is also impressive, because it has never been negative in the last 3 years, and has gone as high as 1.8 % in 2011-12, which is quite high based on the figures of its contemporaries in the Auto Sector in India.

Quality of revenues of Maruti has been rather average over the years, without being above 0.23 %, and registering a negative value in 2010. This is not a good sign for the company, as it shows that its net sales are coming with a higher number of credit sales over the last years. Hero MotoCorp's quality of revenues has been lower than 1 % although increasing over the last 3 years, which is a positive sign for the company. This means that the revenues of the companies are reducing their dependence on credit sales.

Corresponding to the unstable quality of earnings, Bajaj's quality of revenues is also unhealthy, being less

than 0 % for all the years, even declining to a value less than -0.5 % in the 2009-10, showing a heavy dependence on credit sales. The quality of revenues is positive for Ashok Leyland, when compared to the other players in the industry, with the value reaching as high as +1.4 % in 2010-11. This highlights the low dependence of Ashok Leyland on credit sales.

Corresponding to the fluctuations in quality of earnings, there have been wild changes in the Quality of Revenues as well of Sundaram, with the figure jumping from -2 % to 6 % within a year. This might be due to the demerger of the entity, which would have resulted in lesser dependence of credit sales. The quality of revenues of TVS, on the other hand, has been in a constant state of decline, from the assuring figure of close to 1 % in 2009-10, and 2010-11 to -0.5 % in 2011-12. This trend, if it continues for the next few years, can prove worrying for the companies.

Eicher's quality of revenues is also very unhealthy, as it is very close to 0 %, and falls close to -0.4 %, showing that the dependence on credit sales, not translating to immediate cash flows is persistent. Force Motors' quality of revenue has shown a corresponding dip, with the value plunging from a healthy value of almost 2.5 % to a negative value in a span of 3 years.

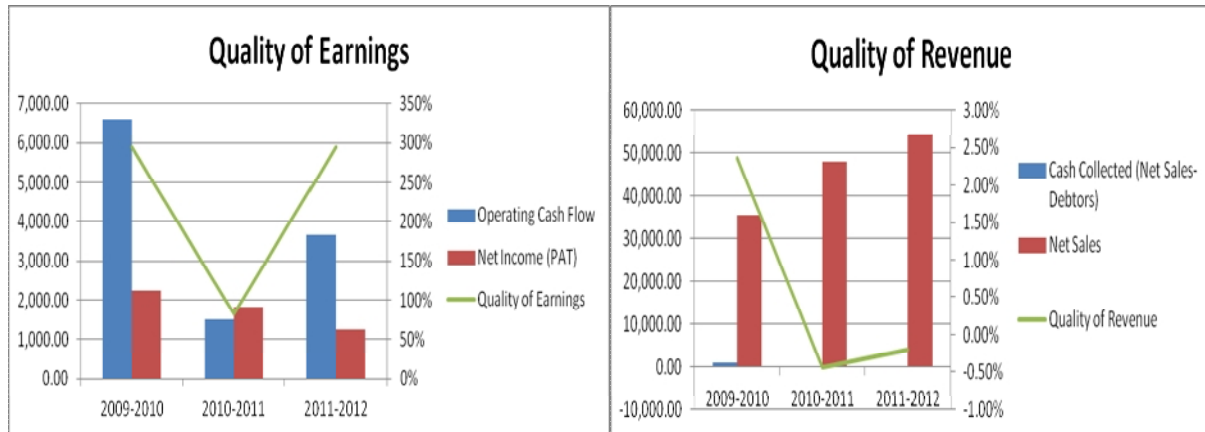


Figure 1. Quality of Earnings & Revenue of Tata Motors

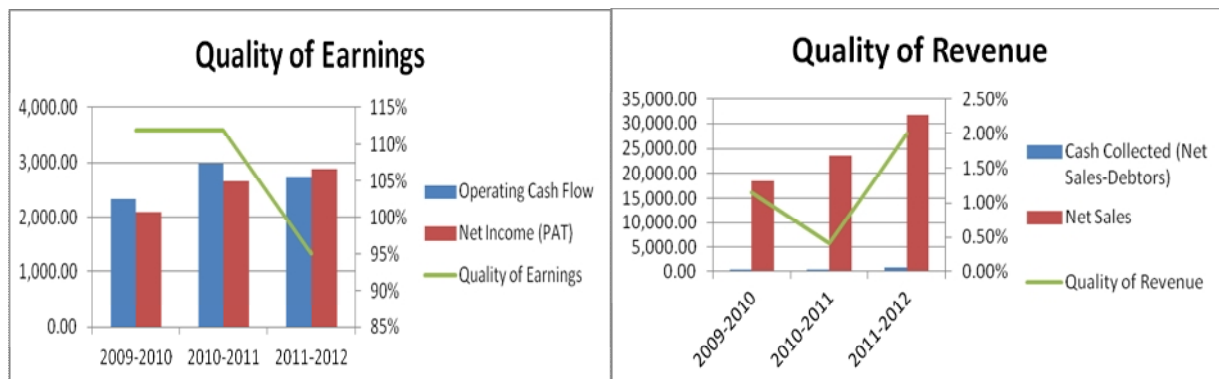


Figure 2. Quality of Earnings & Revenue of Mahindra & Mahindra

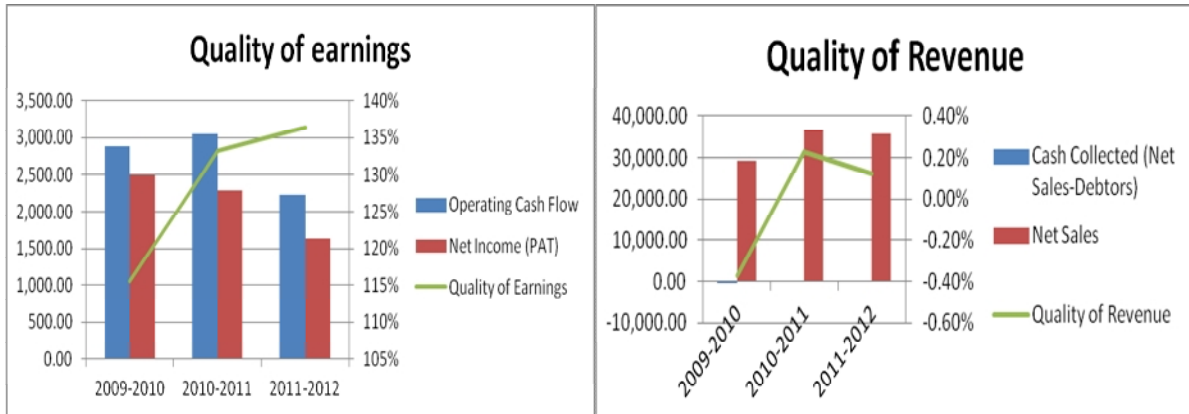


Figure 3. Quality of Earnings & Revenue of Maruti

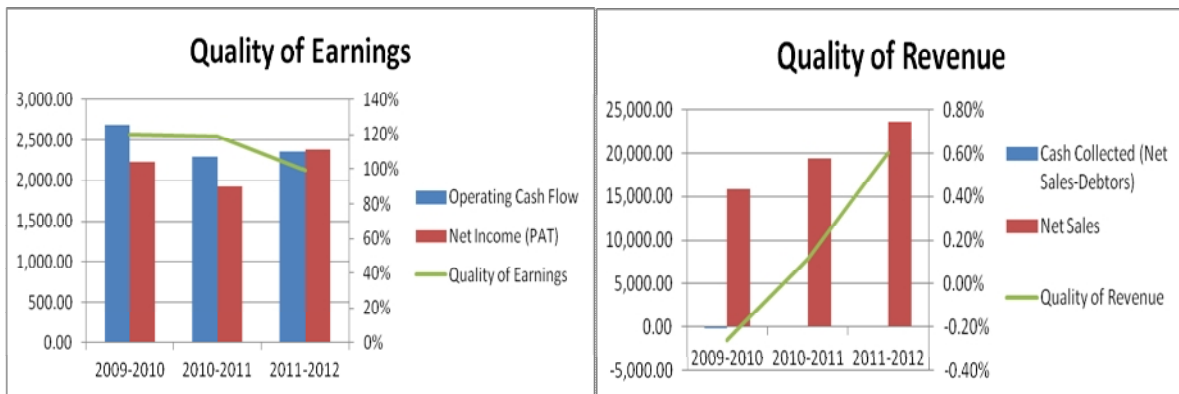


Figure 4. Quality of Earnings & Revenue of Hero MotoCorp

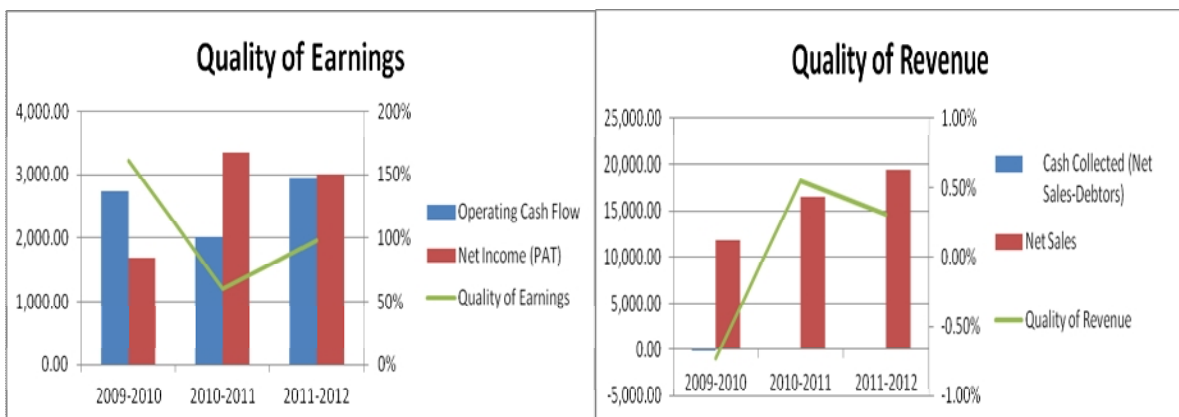


Figure 5. Quality of Earnings & Revenue of Bajaj

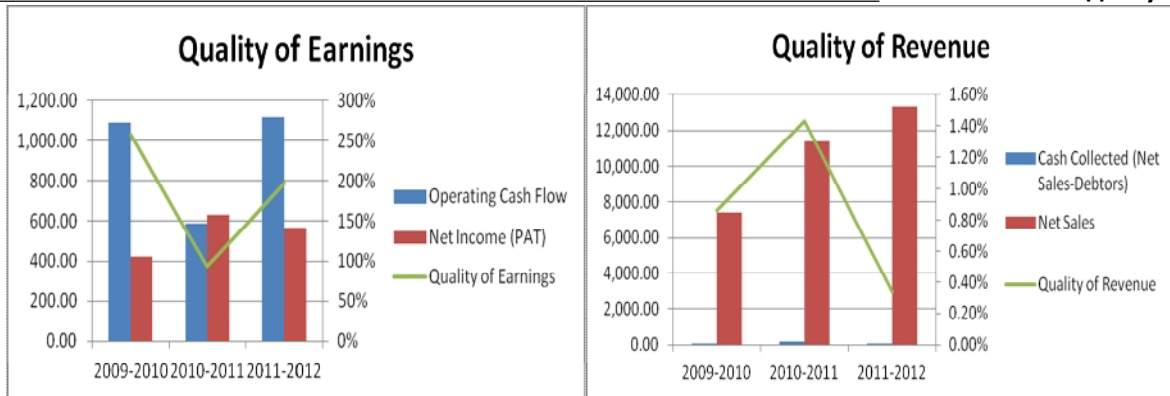


Figure 6. Quality of Earnings & Revenue of Ashok Leyland

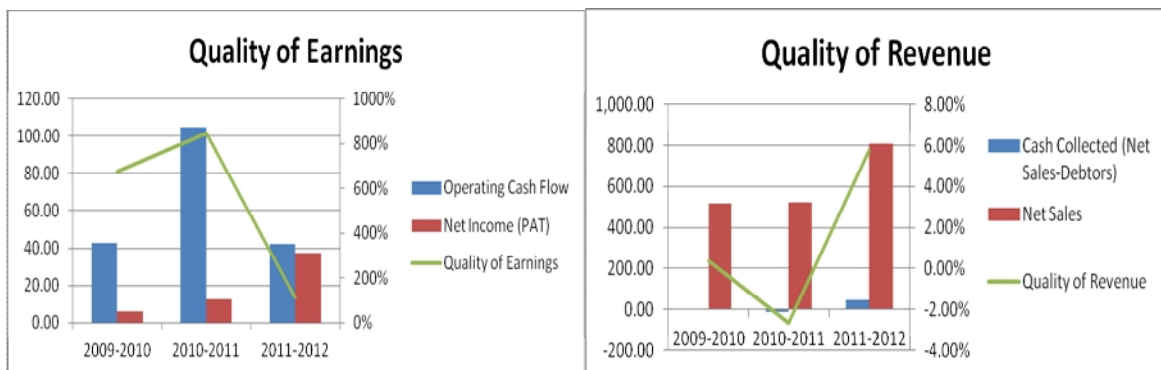


Figure 7. Quality of Earnings & Revenue of Sundaram

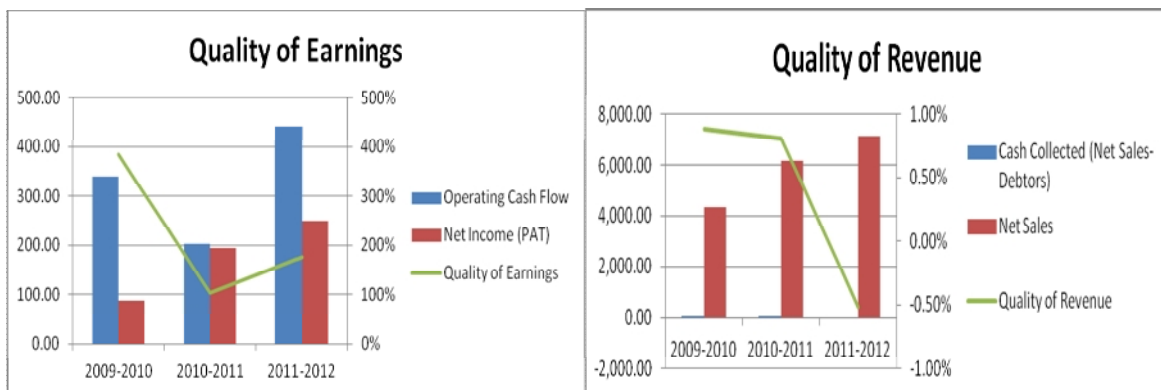


Figure 8. Quality of Earnings & Revenue of TVS

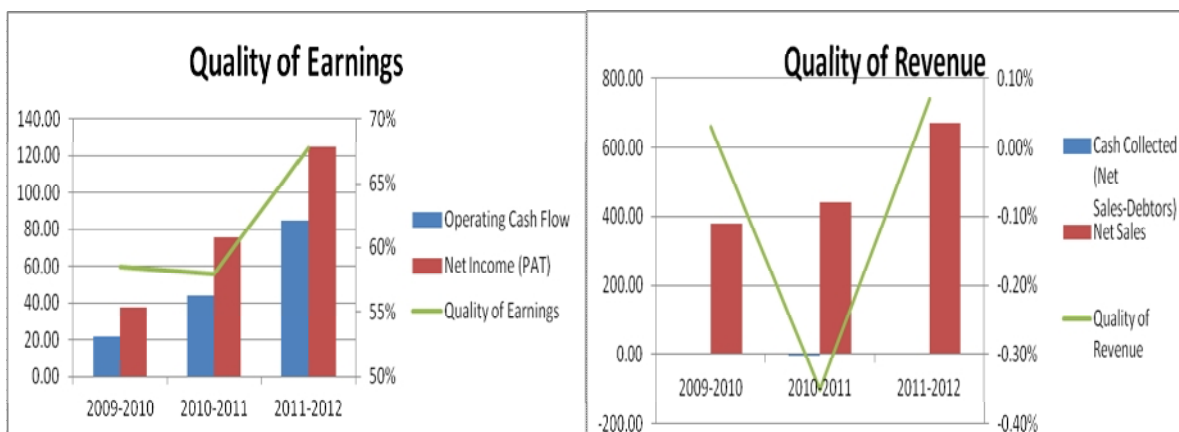


Figure 9. Quality of Earnings & Revenue of Eicher Motors



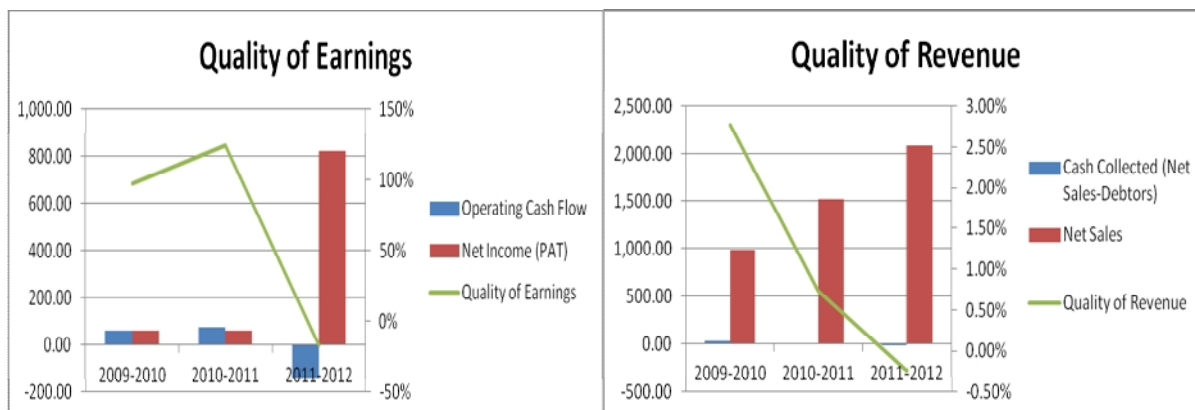


Figure 10. Quality of Earnings of Force Motors

The above analysis presents three different perspectives of quality management of the companies under study. *On one hand*, there are companies, Tata Motors and Mahindra and Mahindra which have shown a steady and promising quality performance for earnings and revenue, whereas *on the other hand* performance of companies like Bajaj Auto and Eicher Motors is worrying being low by the standards. *Besides*, companies like Sundaram Clayton and TVS Motors have shown a fluctuating quality trend, high-low-improving. This too is a concern for long-term viability.

Thus, discretionary behavior by the management of these companies cannot be ruled out. Probable discretionary practices relating to the present case could be liberal credit policy for debtors, the provisioning of bad debts, reporting of operating and non-operating income, accruals treatment.

These are an indication of earnings management which might be a short-term strategy by the management

but ultimately it affects the company and the shareholders; their wealth gets eroded.

Therefore, it raises concern about corporate governance and the way company is being run by the management.

#### B. Correlation Analysis

From the Correlation Analysis, it is evident that out of Quality of Revenue and Quality of Earnings indicators, one or the other shown a consistent matching with the Market Cap. Companies like Tata Motors have shown almost perfect correlation with the market performance. This further proves the point that companies with quality performance are well received by the investors. This can be logically explained by the fact that quality factor influences the Market Value of Equity, so a high value for the equity would result in symmetric growth in both the parameters, as evident in table 1.

Table 1: Correlation Results of Earnings management detection tools

| Company          | Quality of Revenue | Quality of Earnings |
|------------------|--------------------|---------------------|
| TATA Motors      | 0.98               | 0.98                |
| Mahindra         | 0.54               | -0.08               |
| Maruti Suzuki    | -0.76              | -0.53               |
| Hero MotoCorp    | -0.26              | 0.62                |
| Bajaj Auto       | -0.89              | 0.96                |
| Ashok Leyland    | -0.83              | 0.95                |
| Sundaram Clayton | 0.25               | -0.37               |
| TVS Motor        | 0.96               | -0.04               |
| Eicher           | 0.66               | -0.13               |
| Force Motors     | 0.45               | -0.42               |



## 6. CONCLUSION, LIMITATIONS & IMPLICATIONS OF THE STUDY

Earnings management is seen as a negative sign not only for shareholders' value but also for corporate governance to all the stakeholders. Further, it is destructive for the resource allocation in the society.

In the present study, 5 out of 10 enterprises show a discouraging quality level of earnings and revenue. This raises questions about the companies' net income growth and their conversion of operating cash flows. It also indicates their excessive dependence on credit sales. The stability score has not been very impressive either. Bajaj Auto, Eicher Motors and Force Motors showed a declining trend, whereas Sundaram and TVS depicted a fluctuating trend. Remaining units, viz. Tata Motors, Mahindra and Mahindra, Maruti Suzuki, Hero MotoCorp and Ashok Leyland have shown a promising quality performance of earnings and revenue.

So, it is evident that:

§ There are companies in the sector which are exercising discretionary management practices in one way or another. These discretionary practices as mentioned above are an indication of earnings management which ultimately affects the company and the shareholders' value. This becomes a subject of corporate governance as it is about the way company is being run by the management.

§ The lack of transparency inherent in financial reporting system provides the potential to exercise choice by the management. There is an essential requirement for the corporate with growing diversification in the sector to recommit to developing and enforcing corporate governance system that creates a corporate climate of transparency and full disclosure to investors. Probably, the Indian Companies Act, 2013 prove to be the answer for this need.

§ As India is poised to be one of the fastest growing automotive markets worldwide over the next decade and is slated to move up the position in the passenger vehicle market, the vision is required for the 'QUALITY' for effective corporate governance. This will enable the sector and the nation to harness this opportunity for the much required robust industry growth.

### Limitations

There are some limitations of this study which could be categorized as under:

The present study could be confined to only leading diversified auto corporate enterprises in India, on select basis due to data non-availability.

The time period covered in the present study has been of three years from 2008-09 to 2010-11.

The earnings management has been highlighted using quality tools only.

### Implications for further study

The road for future research in the area can be laid down from the above limitations.

One implication of the above review is that analyzing earnings management behaviour is very fruitful area for academic research in Indian perspective, particularly in a diversified sector like auto sector. So, earnings' behaviour scope can be further examined for other

companies in same sector and in other sectors as well and also for other motivational parameters in the light of growing investors' awareness about financial reporting by the management for corporate governance.

Various earnings management tools, developed specifically for detecting earnings management, can be used for making the results more impactful.

Earnings management scope can be further examined, apart from quality and stability score for corporate governance. Continuing efforts are needed to bring out the adversities of earnings manipulation and its impact on corporate governance.

All these possible areas will definitely add to the literature and strengthen it further. They will encourage future research opportunities in these fronts that are likely to enrich understanding of the earnings management phenomena for corporate governance for stakeholders' at large.

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### Appendix I: List of Companies under study

| Company                  |
|--------------------------|
| Tata Motors Ltd.         |
| Mahindra & Mahindra Ltd. |
| Maruti Suzuki India Ltd. |
| Hero MotoCorp Ltd.       |
| Bajaj Auto Ltd.          |
| Ashok Leyland Ltd.       |
| Sundaram Clayton Ltd.    |
| TVS Motor Co. Ltd.       |
| Eicher Motors Ltd.       |
| Force Motors Ltd.        |