ABSTRACT

Public Sector undertakings are grouped into Maharatna, Navratna and Miniratna based on their capital, total assets, income and benefit. This paper provides a comparison about earnings management within these companies by employing agency costs as proxy. The study involves the usage of secondary data, which was collected from the Prowess database, and the websites of individual companies. The study finds that each of these groups suggest the existence of earnings management techniques in their results. The point of interest is that it is the mid-sized companies (Navratnas) that appear to practice earnings management most among the three. Myriad reasons could explain this and it is suggested this be explored further in later research.

Keywords: Agency cost, Earnings management.

I. INTRODUCTION

This paper provides a comparison about the earnings management trends in Maharatna, Navratna and Miniratna companies in India. Public Sector undertakings are predominantly separated into Maharatna, Navratna and Miniratna based on their money related execution, total assets, income and benefit. Earnings management is the usage of bookkeeping processes to create money associated reports that present an exceptionally positive perception of an organization's business exercises and monetary position.

Earnings management is facilitated by information asymmetry among stakeholders of the firm, which then leads to agency costs. Due to constraints in employing measures of earnings management such as earnings smoothing, loss avoidance etc. this paper employs measures of agency costs as proxy. The premise is higher agency costs indicate greater potential for earnings management within those companies.
As some studies describe investor protection acts as a governing factor influencing corporate policy choices (Shleifer and Vishny, 1997; La Porta et al., 2000). Earnings Management is defined as changing of firms’ reported economic performance by people inside either to misguide some stakeholders or to influence contractual effect (Healy and Wahlen, 1999). Insiders like dominant owners or managers possibly use their power to take advantage over the firm as so gain profit at the cost of other stakeholders. Instances of such benefits include perquisite utilization or the transfer of firm assets to different firms which would be owned by insiders or other members of the family. However, mostly it is seen that some majority shares is just owned by the insiders and not transferred to the non-controlling outsiders.

Thus studies also describes about the legal provision to protect investors which deals with the right to discipline insiders i.e., to replace managers, also to implement contracts to fence insider’s private control benefit (La Porta et al., 1998). Therefore it is proposed that earnings management should be present in countries where legal provisions are weak as the insiders get many private control benefits.

II. LITERATURE REVIEW

In the recent past, studies have been mainly conducted to ascertain the link between various activities of the firms and earnings management. The research which talks about CSR reporting and earnings management (Yip, Van Staden and Cahan, 2008) is one of such instance. This study gives information regarding the connection between CSR reporting and earnings management and this is affected by the political surroundings and not by ethical considerations. Ethics literature acknowledges that the firms should be ethically responsible.

The sample composed of publicly listed firms in the U.S from food and oil gas industries. The study conducted by them based on two U.S oil and gas industry and food industry proves that there exist a negative relationship between CSR reporting and earnings management in the oil and industry. This occurred due to political scrutiny by the government on oil and gas industries due to Arab oil crisis in 1973. On the contrary, less consideration was given to the food industry.
Earnings management is affected by endogenous factors which can alter the new corporate governance rule that was recorded by NYSE and the National Association of Securities Dealers. The new rules mandated that many independent directors were working on the boards. This was to develop the monitoring by the board and financial statement in particular.

A study (Chen, Cheng, Wang, 2015) considered the impacts of indirect changes. Their findings were quite interesting. Compliant firms on an average were compared to non-compliant ones which results an experienced a fall in earnings management. With data of the acquisition cost, the non-compliant company were considered to be diminishing. It shows that, increment in board independence alone cannot produce a reduction on earnings management, a large resource data can assist the supervision of independent directors that can produce an outcome of reduction in earnings management.

The study conducted was quite large, taking 1587 firms having data from BoardEx for the period from 2000 to 2005. To yield with the administrative requisite, non-compliant company have to boost bond independence.

A study on earnings quality (Dechow, Ge, Schrand, 2010) observes that there is minimal proof to connect fundamental performance and earnings quality even though the feature of a company’s earnings rely upon the financial performance and the accounting system as well.

One of the major factor that affects business houses today is the legal system that prevails in a country. Different countries have different levels of legal protections and institutional frameworks. A study by Leuz, Nandab and Wysockicis carried out an international comparison between Earnings management and investor protection.

The study analyze orderly variation in earnings management over 31 countries. The study shows that the company proposes an explanation for variation in earnings management based on the ideas of the insiders, they use the earnings management to cover the firm’s performance from the outsiders, to protect their private control benefits. Findings of the study is reliable with this estimate and propose an indigenous relation between commercial governance and the excellence of reported earnings.

The data collected from World scope Database, covers ten years of financial data. The research has grouped the countries
by means of related legal and formal characteristics. Three groups were formed - Outsid\er economies through huge stock markets, distributed ownership, robust legal systems and solid administration e.g. US and UK; insider economies by feeble legal implementation e.g. Italy and India; Insider economies with fewer established stock markets, intense ownership, weak investor rights, but robust legal implementation. E.g. Germany and Sweden

Outsider economies with solid legal enforcement seem to have lowest earnings management and insider economies with frail implementation the maximum level of earnings management.

The current paper employs asset utilization ratio and expense ratio as measures of agency cost which will proxy for earnings management. A low asset utilization ratio indicates poor utilization of assets revenue generating capability (Henry, 2010). This could be due to management adopting poor decisions or deliberately affecting operations in order to manage earnings.

Similarly, expense ratios (which measures the control a firm has over its discretionary expense) can indicate management misappropriation. These expenses consist of monetary and non-monetary benefits enjoyed by management and so they may use these to report higher or lower profits i.e. there is the opportunity to indulge in earnings management for selfish purposes (Henry, 2010). A high expense ratio indicates high agency cost and therefore greater potential for earnings management.

III. RESEARCH METHODOLOGY

The study involves the usage of secondary data, which was collected from the Prowess database. The Prowess database is one of the largest database by the CMIE outlook consisting of 25000 and more companies and their financial data consisting of listed and non-listed companies in NSE and BSE. Financial and non-financial data were collected for selecting the sample on the basis of various levels of the companies, i.e. Maharatna, Navaratna and Miniratna companies. As per the Prowess database the non-financial companies are more than 38000 comprising the 18 categories of manufacturing industries.

Asset utilization ratio is calculated as total annual revenue divided by total annual assets. Expense ratio is calculated as operating expenses divided by annual sales. This is an adaptation of Rashid, 2016 and
differs from his definition due to data constraints such as information on loss of sale of assets.

The final sample consists of 21 companies as under:

- Maharatna 6
- Navaratna 7
- Miniratna 8

IV. ANALYSIS AND RESULTS

The Asset Utilization ratios and expenses ratios were found out from the data analysed on the various groups of companies. The expense ratio the ratio of operating expenses of the companies to gross operating income. The values of expense ratio over the years 2014, 2015 and 2016 are explained with respect to Maharatna, Navaratna and Miniratna companies.

\[\text{Expense ratio} = \frac{\text{Operating expense}}{\text{Gross operating income}}\]

Here we can see that the trend in the expense ratio of the Maharatna, Navaratna and Miniratna companies shows a decrease over the years as shown in figure 1. This might be due to the returns they have achieved over the three year period. But when looking at each companies we can see that the Navaratna companies experiences the highest expense ratios.

Overall the expense ratio is falling over the years. This indicates that all three groups are reducing the agency cost in their companies. Among them, Miniratnas seem to be reducing earnings management the most (as measured by this proxy). Navratna companies seem to be reducing the extent of earnings management but are still the most opaque. Interestingly, the first (Maharatna) and last (Miniratna) seem to have lower extent of earning management than the middle tier of companies i.e. (Navaratna). This could be due to legislation common to the Maharatnas and Miniratnas, or perhaps their ownership structure. Further study could determine these factors.

Figure 1: Expense ratios
The Asset utilization ratio helps in calculating Total revenues earned for each dollar of assets a company earns.

\[ \text{Asset Utilization} = \frac{\text{Total Revenue}}{\text{Total Asset}} \]

The asset utilization ratios provide results that largely concur with expense ratios. Miniratnas demonstrate the highest improvement in asset utilization ratio and therefore indicates least earnings management. Similarly, Maharatnas show the greatest decrease and therefore indicate the most potential for earnings management. Factors affecting this can be field for further study in future.

Figure2: Asset utilization ratios

V. **CONCLUSION**

The Asset utilization and expenses found out from the data analyzed on the Maharatna, Navaratna and Miniratna companies shows that there was a decrease in the expense ratio trend over the three years, which indicates that all three groups are reducing the agency cost in their companies. Among them, Miniratnas seem to be reducing earnings management the most. Navratna companies seem to be reducing the extent of earnings management but are still the most opaque. The first (Maharatna) and last (Miniratna) seem to have lower extent of earnings management than the middle tier of companies i.e. (Navaratna). The results obtained might be due to legislation common to the Maharatnas and Miniratnas,
or it might be due to their ownership structure.

According to the Asset utilization ratios, Miniratnas demonstrate the highest improvement in asset utilization ratio and therefore indicates least earnings management and Maharatnas show the greatest decrease and therefore indicate the most potential for earnings management.

VI. REFERENCES