ROLE OF EARNINGS MANAGEMENT AND CAPITAL STRUCTURE IN SIGNALLING EARLY STAGE OF FINANCIAL DISTRESS: A FIRM LIFE CYCLE PERSPECTIVE

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ABSTRACT

Globally, the unravelling of the corporate scandals leading to big multinational firms stumbling down to bankruptcy suits caused enormous loss of wealth to the investors. In Indian context, the Satyam debacle in 2009, which is considered to be perhaps the biggest corporate fraud in the Indian scenario, causing a loss of Rs. 14,162 crore to investors shook the Indian regulators and lawmakers [1]. The dysfunctional corporate governance and managerial opportunistic behaviour led to misrepresentation of financial statements. The manipulation of the reported numbers by the agents had been achieved through a plethora of routes. To name a few, the allegations in the corporate failures ranged from inflating revenues, overstating profits, capital expenditure, channel stuffing, improper revenue recognition to inappropriate usage of off balance sheet items.

While understanding the precursors of the accounting frauds, the 'earnings management' practices adopted by managers raise a host of questions on the legitimacy of the reported numbers. In India, earnings management as measured by the discretionary accruals amounts to 2.9 % of the total assets as compared to 1% in the U.S. Earnings management activities have also been reported to vary with firm size, with small firms reporting 10.6%, medium firms at 0.4% and large firms at 0.3%.[2] Firm size in turn is considered to be a function of a firm life cycle as the small and large firms are considered to differ on age, size and the information availability (Berger & Udell, 1998). Similarly, the availability of sources of finance varies with the financial growth life cycle ranging from angel financing to raising public equity.

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[1] Central Bureau of Investigation Report, Satyam Case 2009
[2] SEBI DRG Study (2013)

The capital structure of the firm has a bearing on the monitoring of firms by the stakeholders and demand for information pertaining to financial health of the firm. The information quality of the reported performance indicators reflects the distressed financial health of the firm (DeAngelo, DeAngelo, & Skinner, 1994).

This study explores the relationship between firm life cycle and earnings management. It also focuses on the impact of capital structure on earnings management and how the earnings management and capital structure can signal the early stage of distressed financial condition of firms during the firm life cycle in Indian listed companies. The findings of the study indicate that firms in decline stage have higher negative accruals than mature firms. Earnings management as measured by the discretionary accruals quality is significantly related to the capital structure. Earnings management as measured by discretionary accruals quality can successfully predict the early stage of financial distress in the growth stage of firm life cycle. Along with addressing the gaps in literature, the findings of research can have implications for various stakeholders of a firm. Understanding information embedded in discretionary accruals and leverage during various life cycle stages can lead to better investing, financing and operating decisions. The model can help in assessing the financial health of the firm based upon the earnings management activity, leverage and the stage in the life cycle.

Keywords: Earnings management, accruals quality, financial distress, capital structure, debt financing, firm life cycle.

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