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Earnings management and organizational performance: Pakistan VS India

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ABSTRACT

Earnings management is a process of consciously taking steps in the area of accepted accounting principles in order to deliver reported earnings to expected profit. The purpose of this study is to elaborate the impact of earnings management on the organizational performance construction and material in Pakistan and India. The sample of this study was 20 listed companies of Karachi Stock Exchange (Pakistan) and 20 of Bombay Stock Exchange (India) for the period of 2009-2013. OLS technique was applied for hypothesis testing. This study indicates that there is a significant negative relationship between earnings management and organizational performance in Pakistan. On the other hand, there is an insignificant relationship between earnings management and organizational performance in India. Moreover, there is a significant mean difference of Pakistani and Indian construction sector firms’ discretionary accruals, return on assets and return on equity.

Keywords: Earnings Management, Discretionary Accruals, Organizational Performance

INTRODUCTION

Earnings, sometimes called the “bottom line” or “net income,” are the single most important item in financial statements. They all are determined that how much a company involves in value-added activities. Basically, the theoretical value of a company’s stock is the present value of its future earnings. Closing the reported profit to profit target is done by manual accounting. Earnings management is defined by Schipper (1989) as “the process of taking deliberate steps within the constraints of Generally Accepted Accounting Principles (GAAP) to bring about desired level of reported income”. It is one of the tools used for handling accounting information due to gaining profit in capital markets through trade. Earnings management plays when managers decide to use judgment and verdicts in financial reporting and to either influence contractual outcomes that depend on reported accounting numbers or to mislead some stakeholders about the underlying economic performance of the company (Healy and Wahlen, 1999). Earnings may also be coped through real operating decisions by managers and administrators. Accounting researcher extensively investigated the Earnings management through manipulation of firms’ accounting accruals (Healy, 1985; Jones, 1991; Teoh et al., 1998a, 1998b).

It is the aim of management to construct larger financial institutions to benefit from the augmented compensation...
and reputation associated with the industry leading firms. Managers usually are motivated to manage earnings such as their firm achieving high performances, to accomplish this goal. This leads to the birth of results management. The strategic management of results can define as basically the involvement of the management of a company in the financial process information presentation to obtain at the expense of other parties (Cormier et al., 1998, p.119). Earnings management relates to the use of discretionary accounting accruals to influence reported earnings (Jones, 1991). Literature examines that the subset of earning management is real earnings (activity) management, in which firm’s underlying operation altered by managing earnings (Baber et al., 1991; Dechow and Sloan, 1991; Bushee 1998; Roychowdhury, 2006).Income is manipulated by managers using several tools, but the main resources are classified into four categories based on different studies (Ayers, 1994; Bruns and Merchant, 2005; Francis, 2001) (1) Discretionary accruals and liabilities estimation (2) Recognition of revenues (3) Generous reserve accounting and excessive provisions (4) Intentional minor breaches of financial reporting requirements that aggregate to a material breach. Hutton et al. (2009) state that firms with constantly large discretionary accruals are estimated more likely to be manipulating earnings, or at the very least, have less transparent financial statements. Healy (1985) concludes that managers use discretionary accruals to manipulate bonus and additional income. Sloan (1996) shows that the market does not seem to completely recognize the information content of accruals management, and Dechow et al. (1996) argue that earnings management can be detected by patterns of large discretionary accruals.

A different line of research focused on how firms may influence, or manage, reported earnings through their choices of accounting policies. For the measurement of thrust and extent of earnings management, residual accruals are often used. Earnings are divided into cash flows and accruals. Most often analyzed are only the current accruals relating only to working capital. Practitioners and regulators besides theorists have offered ample interest in assessing whether poor quality accounting results is costly for business or not. Managers are granted fair amount of latitude to engage in accounting practices, such as earnings management by accounting principles, especially in rich context in information asymmetry as Initial Public Offerings (IPOs). Past studies show that IPOs cope with their earnings aggressively and opportunistically through income-increasing accruals to increase offering proceeds in the IPO year. Mizik and Jacobson (2007) study the administration of marketing expenses to manage earnings and also investigated its influence on long term performance of the firm. Though the increase in earnings seems satisfactory in current change in expenses and sales of assets, but in long run there would be reduced income and stock. Chapman and Steinburgh, (2011) study the different marketing expenses used to meet the earnings targets and found the impact of these change in expenditures on firm future performance and its competitors. Managers are also found to sacrifice the long run earnings to achieve the forecasted earnings; hence negative impact of manipulation in expenses to the firm’s future performance can also be amounted.

The literature review tells that due to earnings management there is a misrepresentation of accounting figures and untruthful information of firm’s performance. As it is assumed that markets are efficient i.e. symmetry (same) information is available in the market to the investors. McNichols and Stubben, (2008) findings indicate that firms manipulating earnings do over-invest in the misreporting period. Due to market efficiency investors can only generate normal profit which depicts that they do not over-invest in the firms as no abnormal profits are expected. In order to increase the financial performance of the firm, company management gets involved in earnings management which leads to the asymmetry of information thus market becomes inefficient or vice versa as (Chung et al., 2009) show that when the level of information asymmetry is high and the shareholders do not have sufficient resources to monitor the managers, they are more likely to manage the results. Bhattacharya et al. (2007) report that among the outcome of poor accounting results is the surge in information asymmetry leading to more liquidity costs. The intuition behind the poor quality results that lead to information asymmetry is extended to the very nature of accruals. The accruals allow the forecast of future cash flows. Therefore, in accordance to the past researches there is one group of researchers who favors earnings management as firms’ financial performance is increasing as forcing investors to over-invest whereas the other group of investigators does not support earnings management as it makes difficult for the firms to raise financing thus decreasing the firm’s performance. So either earnings management is increasing or decreasing the firm’s financial performance is yet to be exploited as the prior researches do not predict the true figure of the relationship between earnings management and financial performance of organization.

Though, numerous past researchers studied different factors impacting profitability of firms, including working capital, capital structure, leverage, size, operating cycle, investment, and many others (Raza et al., 2011). The dimension in this study is earnings management influencing the performance of firms practiced in two Asian markets i.e. Pakistan and India. We are conducting a comparative study specifically between these two states because of several reasons i.e. Pakistan and India came into being in the same year, before their
independence, the people of both nations have lived together for a long period of time due to this they were brought up in the same culture, thus the thinking and perspectives regarding their lives, activities and most importantly business practices are almost based on same preferences. Though India is quite big country in size relative to Pakistan, the both countries come at par when financial markets are concerned. But in the recent years, it’s been highlighted in economic surveys that India had become an emerging market such as China whereas Pakistan is still riding towards it. So to know how much earnings management is playing its role towards the profitability of organizations in both the countries thus leading the both markets towards global competition, this research has been conducted. To what extent earnings management is being practiced in the firms within Pakistan VS India and how much earnings management affecting firm’s financial performance.

Objectives are achievable goals so the purpose of the present study is to examine the application level of earnings management in construction and materials sector in Pakistan and India. This study further analyzes the impact of earnings management on organizational performance in Pakistan and India.

**Literature Review**

There are numerous studies made to discover this usual practice of income manipulation and to file its trend inclined by various market prospects. These researches specifically highlights that generally income is managed towards the market opportunities but meticulously due to the future predictions of the earnings. The following journalism mainly puts the light on various factors and situations, which lead the managers to involve in the practice of earnings maneuver in order to achieve their goals or toning the market. However, the extent to which earnings management had been practiced and the performance of the organization were discussed in different countries with different factors. To know whether there exists any relation among the two variables, following literature would provide the empirical evidence. Executives employ discretionary accruals to influence additional benefits (Healy, 1985). Sloan (1996) showed that the information of earnings management is not completely distinguished by the marketers. However, the use of large amount of abnormal accruals can spot the activity of managing the profit (Dechow et al., 1996). But why this earnings manipulation had been practiced? Further studies would elaborate it. Degeorge et al. (1999) predicted that executives employed misrepresentation of earnings to attain an anticipated height of profit in order to make some earnings management i.e. false representation of earnings by the executives on the way to gain predictable return intended for unusual pronouncements such as assessment preceding trends of income or impacting forecasts of financial analysts’. This in other words translated earnings manipulation as managing the investors’ behavior or imaginations.

Jin and Myers (2006) presented that managers detain a fraction of the firm’s cash flows because of deficiency of complete transparency with reference to profitability of firm. Mangers might manage earnings to trounce the temporary losses to shield their positions, in order to evade disclosing negative performance. Yet, managers might be reluctant or to hide any more losses if performance was quite worse. Furthermore, (Tehranian et al., 2009) tested the former model by developing a tool of earnings management which was specific to the firm predicting higher crash risk at the particular level of firm. The firms having enormous discretionary accruals were more expected to manage their earnings or at least lesser apparent financial statements. Besides, (Iatridis and Kadorinis, 2009) examined that those companies which needed funds and facing financial distress would opt for income management on the way to raise their accounting figures and stir the investors and funds suppliers afterwards. They found out that exposing the accounting information about firms’ financial decisions and performance which would lessen the extent of income manipulation and compel investors to make acquainted decisions. Moreover, earnings management was used by firms that used to violate debt contracts to circumvent financial sufferings and disappointing the creditors. Managers tend to use earnings management to enhance company performance, raise their compensation and meeting or exceeding the forecasts of financial analysts’. Thus the study concluded that firms that engage in earnings management ordinarily exhibit larger size, higher leverage, lower growth, and inferior profitability.

The literature suggests that firms might be using the discretionary accruals before the issuance of debt and equity i.e. stocks (Beneish, 1999; Erickson and Wang, 1999; Healy and Wahlen, 1999; Shivakumar, 2000; Gaud et al., 2007). The companies main objective behind earnings management is to achieve a lower cost of capital via stating better earnings records in the period around the issue (Hirshleifer et al., 2004). It might also be that there was a high probability of earnings maneuver with increased offerings (Anthony et al., 2006) discovered increase in offerings in relation to increase in the chances of earnings management practices. Before the capital issue date companies might be prone to manage stated earnings upward, to endeavor financing easily in an effort to obtain financing effortlessly and on healthier conditions (Beuselinck et al., 2003; Doukas, et al., 2005). Moreover, Neffati et al. (2011) analyzed the relationship between performance and management in bank mergers. The results indicated a strong diversity in performance of mergers. They studied the relationship between
performance and earnings managements showing that the shortfall ratio was associated with profit manipulation i.e. executives may get involved in practicing aggressive earnings management in order to enhance the performance.

In this study, the dependent variable is the organizational performance, which can be stated as firm performance. In the study, the independent variable is earnings management which is related to accounting figures as discussed earlier so here the dependent variable would be considered as financial performance of the firm. Many management researches had used this term to determine the economic goals of organizations in other words depicting the firm’s performance (Barney, 2002). In the past researches, the measures used for finding out financial performance were the profitability ratios which were commonly used to determine the profitability of the firms such as return on assets or investment, return on equity (Hoskisson et al., 1999). Kordestani and Roudneshin (2006) observed cash and accrual components accounting earnings and firm’s market value i.e. cash as well as accruals and the degree of correlation between the two. Their research identified a significant correlation with company’s market value in case of cash components rather than accrual ones. This explained that accruals being the proxy for measuring earnings management did not affect market value of the organization, depicted insignificant results. Moreover, earnings management is used by firms that used to violate debt contracts to circumvent financial sufferings and disappointing the creditors. Managers tend to use earnings management to enhance company performance, raise their compensation and meeting or exceeding the forecasts of financial analysts’. Thus the study concluded that firms that engage in earnings management ordinarily exhibit larger size, higher leverage, lower growth, and inferior profitability (Iatridis and Kadorinis, 2009)

It was elaborated further that the cost incurred through aggressive accounting is greater than the cost expensed due to earnings manipulation complying to accounting principle i.e. GAAP (Jiambalvo, 1996). So shareholders confined to earnings management that is within the accounting standards which used to benefit the external owners as well. This might explain the association between the external shareholders and manipulated earnings reporting. Thus by enhancing the benefits to the stockholders, monitoring would get effective and no breach of GAAP hence reducing the practice of income management by the organization (Dechow et al., 1996); Verbruggen and Christiaens (2010) highlighted the impact of earnings management in nonprofit organizations in the presence of governmental subsidies. They found that earnings management towards zero profit is positively related to the level of subsidies for unexpected depreciation as well as discretionary accruals. The evidence of the empirical researches is also found in the literature which actually indicated the association between the independent variable i.e. earnings management and the dependent variable i.e. organizational performance. Though many past researches found out the link between earnings misrepresentation and the information disclosing factor (Allayannis and Simko, 2009; Iatridis and Kadorinis, 2009; Riahi and Ben, 2011), others talked about the association of exposed information and liquidity of instruments (Gana and Chemli, 2008) whereas, the studies on direct connection between the organizational performance and earnings manipulation are comparatively inadequate. Moreover, when emerging markets are considered, researches on the stated relationship are even sparser.

DeFond and Park, (1997) studied the relationship between the accruals and performance and found out the negative correlation among the two but also indicated the positive relationship when considering the future year profitability. That is the reason executive practiced income misrepresentation in order to save the earnings for later years. However, the firms which report constant earnings throughout the years, are relatively attract more investors. Investment became less risky in such firms and also building more confidence of shareholders (Habib et al., 2011). Moreover, the association between the two had been studied in stock acquirer firm perspective. Ardekani et al. (2012) documented the association between acquisition, earnings management, and firm’s performance in Malaysian context and discovered a negative relationship between earnings management preceding and performance of firms’ subsequent acquisition date for share acquirer firms.

On the bases of literature review following hypotheses are developed. The prior literature supports the outline which states that earnings management either enhances or declines the organizational performance.

H1 There is significant impact of discretionary accruals on ROA of Pakistani construction sector firms.
H2 There is significant impact of discretionary accruals on ROE of Pakistani construction sector firms.
H3 There is significant impact of discretionary accruals on ROA of Indian construction sector firms.
H4 There is significant impact of discretionary accruals on ROE of Indian construction sector firms.
H5 There is a significant mean difference of Pakistani and Indian construction sector firms’ discretionary accruals.
H6 There is a significant mean difference of Pakistani and Indian construction sector firms’ ROA.
H7 There is a significant mean difference of Pakistani and Indian construction sector firms’ ROE.
METHODOLOGY

The discretionary accruals known as abnormal accruals, may be reported due to opportunistic behavior of managers and therefore show the way to reduce the apparent trustworthiness of earnings. Due to this characteristic of discretionary accruals, managers get a chance to manage the income figures thus used as a pointer of earnings management (Jones, 1991; DeFond and Jimbovalo, 1994; Dechow et al., 1995; Teoh et al., 1998a, 1998b; Bartov et al., 2001; Bowman and Navissi, 2003). Earnings management can be done through two approaches i.e. real earnings management and accrual based earnings management. Zang (2012) demonstrated that managers use accrual earnings manipulation and real earnings manipulation as alternate. We are using discretionary accruals as now a day’s accrual based accounting is being practiced by the companies due to the use of accrual system in the market that’s why we are going to study the second approach i.e. accrual based earnings management affecting organizational performance. Neffati et al. (2011) researched on banking performance and earnings management and applied stochastic frontier analysis to measure banking performance. Discretionary accruals were computed by applying modified Jones Model. Iramnaz et al. (2011) studied the relationship of size of firm and capital structure on income management. They also applied Jones model for the estimation of discretionary accruals and robust regression was used. Jaiswal and Banerjee (2013) explored the link between profit manipulation and characteristics of corporate governance, estimating the accruals by OLS with industry and year combination. In the above discussion different techniques (stochastic frontier analysis, regression analysis, value relevance model, OLS multiple regression model) were used to measure this concept and in the present study OLS regression model was applied.

It is studied the relationship of two variables i.e. earnings management and organizational performance. The proxy being used for measuring earnings management is discretionary accruals (Dechow et al., 1995) whereas the proxy being used for organizational performance in this research were return on asset i.e. ROA supported by past researchers (Rangan, 1998; Mizik and Jacobson, 2007; Gunny, 2010) as well as return on equity i.e. ROE (Zeitun and Tian, 2007; Iqbal et al., 2012; Tabassum et al., 2013). We had taken the data related to above mentioned proxies from the financial statements of 20 listed companies out of 36 in “construction and materials” sector on the Karachi Stock Exchange (KSE) of Pakistan whereas from Bombay Stock Exchange (BSE) data from 20 listed firms out of 46 from the same sector was extracted in India. Due to the problem of missing data the empirical analysis concentrates on the period of five years i.e. 2009 to 2013.

The financial data had been collected from the financial statements of 20 listed companies in the specified sector which were fetched from the annual reports of the companies available at their official sites of both countries. As the data being used was only electronically available that’s why the sample had been reduced to only 20 companies. In the present research three variables (proxies) are used i.e. discretionary accruals, ROA and ROE. Where, the impact of discretionary accruals (the independent variable) was studied on ROA and ROE (the two dependent variables) in this research including two countries; Pakistan and India. We used cross-sectional modified-Jones model to obtain the discretionary (abnormal) accruals (independent variable) for measuring earnings management (Dechow et al., 1995 following Jones, 1991). Financial ratios were used to measure the organizational financial performance (Maes et al., 2000).

Modified Jones model (1991) was applied on the data obtained from both the countries under study due to comparative purpose included following equations:

\[
T_{\text{Act}} = \text{Non} \times D_{\text{Act}} = D_{\text{Act}}
\]

\[
T_{\text{Act}} = \Delta C_{\text{Act}} - \Delta C_{\text{Asht}} - \Delta C_{\text{Li}} + \Delta S_{\text{Dt}} - D_{\text{Pt}}
\]

\[
\text{Non} \times D_{\text{Act}} = 1(1/\text{At}-1) + 2(\text{REV}_{\text{t}} - \text{REC}_{\text{t}} / \text{At}-1) + 3(\text{PPET}_{\text{t}} / \text{At}-1) + \varepsilon
\]

Table 1 above. However, the return on total assets (ROA) is calculated as ratio of earnings before tax to the total assets.

\[
\text{ROA} = \frac{\text{Earnings before tax in year } t}{\text{total assets in year } t}.
\]

Return on Equity (ROE) is calculated as ratio of earnings before tax over total equity.

\[
\text{ROE} = \frac{\text{Earnings before tax in year } t}{\text{total equity in year } t}.
\]

After collecting the raw data and calculating the proxies, the data of our three variables was then pooled for further analysis.

As present data consisted of accruals so the most appropriate technique to measure for analysis is OLS i.e. ordinary least squares (OLS) or linear least squares which used to calculate the unknown parameters in linear regression model (Jaiswal and Banerjee, 2013). The data being analyzed had linear parameters and was normally distributed so the variables can be calculated as a linear function of a specific set of independent variables plus a disturbance term. There was no autocorrelation between the data and the current values of error term were independent of its previous values which explained that disturbance terms were separately distributed and were not correlated to each other.

RESULTS AND DISCUSSION

Descriptive Statistics

The above Table 2, illustrates the descriptive statistics of
the two countries. In Pakistan, the mean value of discretionary accruals in the selected sector is -2300110.6 whereas; in India it is -8769535.9. The maximum amount of discretionary accruals in India is 17258037, which means more abnormal accruals are reported by India rather than Pakistan i.e. 6222847.21.

As regard to the ratios, the mean value of return on asset ratio in Pakistan is 2.9726 and India it is 11.4963. The profitability of Indian firms is more as the maximum value of ROA ratio is 162% as compared to Pakistani firms having 38% as maximum value in construction and materials sector. The second profitability ratio i.e. return on equity has a mean value of 19.9321 by India and 3.7549 by Pakistan. The maximum value of ROE ratio of Indian firms is 289% which are relatively more profitable than Pakistani firms in construction and materials sector with a maximum value of 47%. The variation in data is depicted by its standard deviation. The highest value of standard deviation is 41.99 which depicts that the great deviation in the profitability of India is due to discretionary accruals while the minimum variation in profitability of Pakistan has been observed which causes the least variant in discretionary accruals in Pakistan.

Table 3. In Pakistan overall regression model elucidates profitability w.r.t. respect to return on asset approximately 10% (R² = 0.099), whereas in India it is 0.4%. This value shows the variation in the dependent variables due to the independent. The value of R square of Pakistani model is more close to 0 rather than 1, so the model is satisfactory. However, the model does not stand in India as depicted by its R square value i.e. even less than zero. The F-statistics is 10.778 in Pakistan and in India it is 0.412 that determines the significance of the model in Pakistan (as greater than 3.5) whereas in India.
the model stood highly insignificant. The regression analysis of Pakistan shows that the common average for profitability in context of return on asset in Pakistan is 1.695 while for India it is 11.720. Its coefficient is negative and this negative sign shows the negative relation of discretionary accruals with return on asset (ROA). The discretionary accruals are significant as p value is 0.001 (less than 0.05). Here H1 gets proved i.e. there is significant impact of discretionary accruals on ROA of Pakistani construction sector firms. Moreover, the F and p-values are 11.4963 (greater than 0.05), which is greater than 0.05, this explains that discretionary accruals and profitability does not have a relationship when studied in India. In India, the model is highly insignificant disapproving H4 i.e., there is no significant impact of discretionary accruals on ROA of Indian construction sector firms.

The independent simple t-test measures the level of difference of significant with respect to dependent and independent variables between two different countries i.e., Pakistan and India. Table 5.

The results generated in table elucidate the significance level between two respondents i.e., Pakistan and India. The results show that the mean value of Indian companies (-60837225) is higher than the mean value of Pakistani i.e., -2300110.6 firms in construction and materials sector. Moreover, the F and p-values are 11.409 (greater than 3.5) and 0.021 (less than 0.05) which means that there is a significant difference level between the Indian and Pakistani companies regarding the discretionary accruals. Thus proving H5 i.e., there is a significant mean difference of Pakistani and Indian construction sector firms’ discretionary accruals. The results also enlighten the difference in significance level of the dependent variables i.e., ROA and ROE among Indian and Pakistani companies. According to return on asset profitability ratio, significance level of Indian firms is elevated than the Pakistan firms due to the greater mean value i.e., 11.4963 than the Pakistani firms i.e., 3.1387.

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<th>Table 5. Mean Difference Analysis</th>
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The results according to the second dependent variable in our study i.e. return on equity profitability ratio explicate the variation in the significance level between Indian and Pakistani companies. The mean value of ROE of Indian firms is 19.9321 whereas for Pakistani firms it is 7.9688 which show that the significance level is higher in Indian firms as compare to Pakistani firms in construction and materials sector. Furthermore, the F-values (3.740) and p-values (0.055) support the significant mean difference between profitability w.r.t. return on equity (ROE) among the two countries, India and Pakistan i.e. H7. The overall t-test implies that the results of both India and Pakistan groups are significantly different from each other. In addition to this, the mean values in the case of both countries are significant because of their p-values are less than 0.05 and F-values greater than 3.5.

The purpose of this study is to empirically test the relationship of earnings management impacting organizational performance in Pakistan as well as in India. Moreover, the comparative study among the two countries was also analyzed regarding the stated variables. From the past researches it is evident that we found support for first, second, eighth and ninth hypotheses those are related to Pakistan. The result of first hypothesis that discretionary accruals have a significant negative impact on return on asset in Pakistan and the findings for the second hypothesis is discretionary accruals have a significant negative impact on return on equity. However, the results of eighth hypotheses are there is a significant negative association between earnings management and ROA whereas the ninth hypothesis resulted in an insignificant negative association among earnings manipulation and ROE. This explains that the variables have a relationship but they are in opposite direction, meaning when independent variable i.e. earnings management (discretionary accruals) increases, the dependent variable i.e. organizational performance (ROA and ROE) decreases and vice versa. This is exactly what depicted by one of the group of researchers in the past literature. DeFond and Park (1997) stated a negative correlation among the two variables. Naveed et al. (2012) found negative relationship between earnings management and profitability of the firm in Pakistan. Moreover, Fan (2007) argued that practicing earnings manipulation was a costly strategy as the increased or manipulated accruals should be offset by the amount of cash flows. So in the long run, earnings management led to bring decline in organizational performance because of the expense i.e. cost of capital got increased. Ardekani et al. (2012) documented a negative relationship between earnings management preceding and performance of firms’ subsequent acquisition date for share acquirer firms.

It is supported for third, fourth, tenth and eleventh hypotheses that are related to Indian firms of construction and materials sector. The result of third hypothesis of the present study that discretionary accruals have an insignificant relationship with return on asset in India and the findings for the fourth hypothesis is discretionary accruals have an insignificant relationship with return on equity. However, the result of tenth hypothesis shows an insignificant positive association of income manipulation and ROA. The results for eleventh hypothesis suggested an insignificant positive association between earnings manipulation and ROE. This explains that the variables do not have any link between the two, meaning that any change in independent variable i.e. earnings management (discretionary accruals) does not bring any change to dependent variable i.e. organizational performance (ROA and ROE), thus both the variables are independent posing no association. Though these results are totally different from what we found for Pakistani firms but the findings of these hypotheses in Indian context are also marked form the past literature. Algharaballi, (2013) argued about Kuwait capital market related to the two variables. The results indicated a significant relationship among the applications of income manipulation and company’s performance when analyzed with the use of current accrual model. But the findings were insignificant when total accruals were applied. As in our study, we applied total accrual model i.e. Jones model, this evidence thus makes our results considerable. Moreover, Nelson et al. (2002) survey showed that sometimes auditors may ignore the earnings management of big clients, in other words by large sized firms. Ching et al. (2002) examined that whether unrestricted current accruals forecasted the returns and earnings performance and concluded that larger firms were manipulating current accruals to overstate earnings than the small sized firms. This actually depicts that due to the greater size of firm in India relative to Pakistan, minimizes the effect of earnings manipulation on firm’s performance, where there are many other factors affecting its profitability such as size of firm being highlighted, lower profits as (Sun and Rath, 2009) study concluded that small companies having lower profits were more pander to earning management. Moreover, Rui et al. (2002) investigated that the unhindered current accruals forecasted the returns and performance of revenues (earnings). The study pointed out that larger firms are manipulating current accruals to overstate earnings than the small sized firms. There is no association between there isn’t any relationship between cash acquirer firms’ return and income management (Ardekani et al., 2012).

When the comparative analysis was done between the
two countries regarding the three variables i.e. discretionary accruals, ROA and ROE based on fifth, sixth and seventh hypothesis of our research. The result of fifth hypothesis i.e. there is a significant mean difference of Pakistan and India discretionary accruals holds in our findings and shows that the Indian firms have a greater mean difference than Pakistani firms.

The reason behind such findings is that the market capitalization and the size of Indian firms is quite bigger relative to Pakistani firms’ due to which they have greater amount of reported accruals relative to Pakistan (Aslam and Alam, 2012). However, the sixth and seventh hypothesis resulted in higher significant mean difference in profitability ratios i.e. ROA and ROE in India as compare to Pakistan. This is due to bigger size of firms in India relative to Pakistani firms. Because the size of the companies have a positive relationship with firms performance, as it reduces the risk and enhancing the profitability (Velmampy and Nimalathan, 2010). The above discussion concludes that all of our study hypotheses holds and evident from the past studies. The first, second, fifth, sixth and seventh alternate hypotheses are proved whereas the third and fourth null hypotheses hold up in our research.

CONCLUSION

The research conducted on the relationship between earnings management and organizational performance based on the comparison among two countries or in other words the two important Asian markets brought us to this picture that where in Pakistan, the significant negative relationship between the variables shows that the companies are involved in earnings manipulation but could not benefit themselves through increased profitability in long term. On the other side, the Indian firms’ profitability is not affected by earnings management as per our study results. These both findings leads us to conclude that India with greater market capitalization, bigger firm size and little earnings management relative to firms profitability made it an emerging market as compared to Pakistan who is in lead of emerging markets but does not proved to be an emerging market yet because of its smaller market capitalization, smaller firm size and increased earnings management against lesser profitability in order to compete with larger firms, thus still declared as an under developed market.

Like many other research, our work has also some limitations. The sample size of our study is small and limited to that companies whose data are available on the websites. The calculation of discretionary accruals is based on the difference of two years of related variables. Some companies performing earnings management in one year and not performing earnings management in the subsequent years. So, earning management change every year or after two years that may affect the results of discretionary accruals. So, the models used to compute discretionary accruals fall to criticism as depicted by prior literature. Many researchers argue that these models provide noisy estimate that lead to mixed results. Teoh et al. (1999) argue that regardless of the model used, the discretionary accruals tool can be misleading. The model we used to calculate the accruals ignore the net income effects. Due to short time span and data availability our study results are limited to 5 years data. Present study results based only on construction and material sector further research may conduct by comparing the different sectors as well. Further research can also compares the other emerging markets like China and Pakistan. Data collection should be extended and may also include the non-financial sector. Future research may also examine the relationship by using nonfinancial performance measures on the earnings quality that is explained by earnings manipulation behavior. This study examine the relationship between earning management and organizational performance but the further research also includes the other variables such as determinants like ownership structure, managerial incentive structure of the firm to earnings management. The relationship between the under discussion variables can be explored by comparing the total accrual based model and current accrual model for computation.