EARNINGS MANAGEMENT AND THE ROLE OF DIRECTORS

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The Directors of many a companies are quitting their coveted directorships of Indian companies during the last one year. Amongst the varied seasons for their quitting the cushy positions one season is their unhappiness about the way these corporate prepare and present their annual reports which comprise of the financial statements. These financial statements are amenable to manipulations or maneavouring by Corporates owing to the accounting policies adopted by them. The present article highlights some of these policies which are vehemently applied by the corporates and presents a case for the directors' responsibilities in this context.

In spite of the guidelines issued by Department of Company affairs (DCA), The Institute of Chartered Accounted of India (ICAI), Securities and Exchange Board of India (SEBI), there have been a number of corporates still perpetrating the accounting deception by adopting certain accounting reporting practices which don't adhere to these guidelines. With these deceptive practices pervading pervasively the directors of many a corporate entities have been accused of turning a deaf year to public uproars about the deceptive accounting reports attempting to roseate the picture of the corporate profitability. Many a forum these days discuss the responsibility of directors towards the users of these accounting reports.

The accounting reports churned out by the corporate in the form of annual reports consisting of profit and loss account, balance sheet and funds flow statements is purposive statements. To be considered relevant these reports are supposed to be furnishing relevant, accurate and authentic information for varied stake holders including equity investors, lenders, employees and bankers, amongst others.

These accounting reports are meant, first and foremost, for those investing capital (equity shareholders) in and lending resources (lenders) to companies. Their engagement and involvement with the company as investors or lenders and their hard

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earned money invested in the company demand that these reports provide reliable information. The accuracy of these reports in terms of the profit figure reported helps these interested groups take their decisions in the specific area of their interest. Existing as well prospective investors are concerned about their investment in the company for which they seek information in these financial statements. Similarly, lenders like bankers and lending institutions are concerned about the debt repayment capacity of the company for which they too search for the information in these financial statements. However, since the stock prices and therefore the value of the company have been found to be highly correlated with profits reported by the company in these financial statements, the management of most of the corporates have been extremely concerned and interested to see that the reported profit figures are impressive. This gives rise to a situation where the managements of most of the corporates are highly tempted to report the exaggerated profit figures and this practice is all pervasive all around the globe. Even in USA, a research study of Standard and Poor companies has revealed that on the average S&P 500 companies, have overstated their profits by at least 10% during the last two decades thanks to the accounting jugglery or deceptive reporting . Therefore, the notion of window dressing or deceptive reporting in the accounting reports is being talked about even today when the accounting standards have all over the world become far more stringent and the transparency is highly demanded.

Earnings Management: Creative accounting, cooking the books, deceptive reporting, earnings management, doctored reporting, juggling the books of accounts or reengineering accounting and many other different names are being ascribed to the systematic attempt by the corporate to manoeuvre the books of account to show the rosy picture to the outside world about the performance of the company than what the real picture is. This practice had been rampant about a decade ago when many of the accounting standards (AS) were in the formative stage. However, this practice of earnings management still persists though not with the same vengeance owing to the application of strictures in the form of varied accounting standards. Creative accounting refers to accounting practices that may or may not follow the letter of the rules of standard accounting practices but certainly deviate from the spirit of those rules. They are characterized by excessive complication and the use of novel ways of characterizing income, assets, or liabilities. So Earnings Management is the transformation of accounting figures from what they actually are to what perpetrators desire by taking advantage of the existing rules and/or ignoring some or all of them.

This can be achieved through choice and application of accounting policies or through fraudulent financial reporting. The former is the result of flexibility in accounting principles and the latter is a wilful act of deceit to cheat others so as to make personal gains. The effect of creative accounting may defeat the purpose of presentation of true and fair financial statements as required by section 211 of the Indian companies act. It involves those techniques which are openly displayed (window dressing) as well as those which are sophisticated ones (off-balance sheet financing).

There are numerous examples where corporates all over the world have attempted to roseate the accounting reports. The Enron scandal in 2001 is the most glaring example of deceptive accounting reporting in the modern business environment. The accounting scandal was not an isolated incident in the era of deceptive reporting. WorldCom, Halliburton, Rite-Aid Adelphia Communications and Xerox were also found guilty of violating generally accepted accounting principles (GAAP) in preparing accounting reports and trying to show to the world the rosy picture as the real picture. Well established and world famous Global accounting and auditing firms such as Arthur Andersen, KPMG and Deloitte and even Price Water House Coopers (PWC) were also seen as grossly negligent when they glossed over the accounting reports in many of the companies in USA.. In India, the most prominent case is that of Satyam Computers which also dragged price water house (PWC) into the picture and highlighted a serious attempt to roseate the accounting figures for a long spell of time of almost eight years. A common theme among all these accounting deception is the violation of accounting principles in reporting company revenues, costs and profits. Since companies are largely evaluated by investors on the basis of reported revenues and net profits earned on that and company executives are also largely rewarded for making profits with company in the form of stock options, many corporate managements are highly motivated to report accounting reports showing a healthy picture of their firm's profitability.

Accounting practices by Enron could be considered nothing less than deceptive. Enron managed inflated energy costs to benefit the company's net profits. Further, Enron's accounting practices changed public opinion on the dealings of corporate America. Enron's deceptive financial reporting has played a decisive role in making investors highly sceptical of corporate accounting reports and the stock markets. Investors in general therefore must study these financial or accounting records with a pinch of salt.

The fraud and deception at Satyam Computer Services in India was so in-depth that it

included dual accounting books, thousands of forged invoices, and dozens of fake bank statements. Though the deception in accounting it was able to create a perception that the company was "carrying out huge volumes of business" so it attracted potential customers and investors. All the while, cash was flowing into the hands of those who architected the deception and accounting jugglery. The well renowned directors including independent director owe a lot of responsibility for such a reporting.

There have been serious attempts all over the world to take care of this malaise and the regulatory systems are being designed and redesigned such that reporting and audit practices from independent accounting firms following GAAP principles would prevent this from ever happening, but that system has consistently failed number of times during the last few years in many of the countries including India. The practice of roseating the picture or earnings management therefore is persisting in the Indian corporate world.

One of the most important purposes for which the firms use deceptive accounting is to hide managerial inefficiencies. That is, the accounting is a means of making investors believe that the firm's financial condition is stronger than what the actual performance is.

Most of the companies go all out to present a pretty picture of their performance to shareholders by manipulating their financial statements. According to a recent KPMG report a majority of the cases involve accounting tactics are designed primarily to deceive investors. Some of these may not be illegal but are definitely meant to mislead more especially, the investors community. The following are examples of the areas in which different accounting policies may be adopted by different companies creating a breeding ground for deception.

(a) Methods of depreciation, depletion and amortisation
(b) Treatment of expenditure during construction
(c) Conversion or translation of foreign currency items
(d) Valuation of inventories
(e) Treatment of goodwill
(f) Valuation of investments
(g) Treatment of retirement benefits
(h) Recognition of profit on long-term contracts
(i) Valuation of fixed assets
(j) Treatment of contingent liabilities

The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit in the profit and loss account. However, the real scenario is entirely different. There are many a ploys which are adopted by corporate to show the picture different than the real picture. Here are a few common ploys adopted by corporates all over the world including India.

Off-Balance Sheet Financing: One of the most important methods used to exaggerate the profitability by a company is to exclude debt from the balance sheet it shall result in a favourable debt to equity ratio, making a high geared company appear low geared and therefore can easily raise more loans from the banks & institutions. This technique helped Lehman Brothers to disguise $50 billion in debt and remove liabilities from the balance sheet when the results were due, hiding the extent of its debt. Enron in USA had also been found to be expert in putting under the mattress its huge debts it had been taking for a long spell of time. The financial accounting methodologies utilized by Enron not only influenced its own demise as a Power and Energy company, it also sealed the fate of one of the accounting big five, Arthur Anderson which too had to vanish from the consulting world.

Most of the companies in India have also attempted to keep its gearing ratios low by not showing the lease rentals' capitalised value in the balance sheet until the accounting standards AS19 came into existence. It helped in improving the debt equity ratio. The financial leases were not shown as their assets or liabilities and kept it completely as off the balance sheet transaction. Even now it is not difficult for a company to class a financial lease as an operating lease and completely hide its debts to embolden its debt equity ratio.

Inventory Valuation: The selection and application of generally accepted accounting principles (GAAP) is flexible, leaving enough room for judgment in certain areas. For example inventory valuation offers a number of accounting policy choice and estimation decisions for the companies to prepare financial statements. Due to this flexibility the management can be creative in preparation of financial statements. In most cases the management judgment results in change of reported financial results from one direction to another which is generally referred to as closing inventory is the stock left over at the end of the accounting year and its value is often used to enhance profits Value of the closing inventory is the stock left over at the end of the accounting year is often used to

enhance profits. An increase in its value automatically improves the net profit by the same amount. The notes to financial statements point out significant facts relating to this value. Investors must ensure that inventory is valued at its cost or net realisable value, whichever is lower. Most of the companies used to change their inventory valuation policy from LIFO to FIFO method to reduce show cost of production but increase the value of closing inventory before the accounting standard on inventory valuation came into existence. This increases the profitability of the company with a single stroke of pen. In an year a company used to feel interested in increasing its profits it used to change its inventory valuation policy from LIFO to FIFO. However, after the AS-2 was introduced for inventory valuation which allows FIFO or weighted average cost formula the policy change can take place between these two only. This too can be arm twisted to show the profits as desired.

Sales Revenue Enhancement: The most convenient way for a company to deceive the outside world is to show an exaggerated sales revenue figures. A company may consider goods that have been ordered but not shipped as part of its sales revenue. It could also gross up its sales revenue. Evan the interdepartmental transfer can be considered as sales. ROLTA INDIA was accused of reporting the interdepartmental transfer as sales and therefore exaggerated its sales and profits few years ago. Among other methods is including interest income as operating income or considering income from the sale of a current asset as operating revenue. The bloated figure of sales revenue can easily feal to enhanced levels of profits for a company. Anantraj industries a north Indian commercial developer, transferred part of one of its projects (0.52mn sf out of 0.75mn sf in a mall in Delhi) to its wholly-owned subsidiary and consequently showed equivalent revenues in its standalone results (93% of Q1 FY09 revenues). As against standalone revenues of Rs 172 crore and a net profit of Rs 152 crore, consolidated revenues are Rs 104.8 million and net profit of Rs 7.76 crore. Out of the consolidated revenue of Rs 10.48 crore, Rs 6.80 crore (65%) is from the ceramics business.

Most of the construction and developer companies have been found to be changing their revenue recognition policies to enhance the revenues and profits of the company. DLF IN YEAR 2007 IN ITS ANNUAL REPORT CHANGED ITS POLICY OF RCOGNISING THE REVENUE. IN THEIR ANNUAL REPORT IN NOTES TO THEIR ACCOUNTS THEY MENTIONED THAT ---- Pursuant to the Guidance note on Recognition of Revenue by Real Estate Developers, issued by the Institute of Chartered Accountants of India ("ICAI"), the Company has changed the accounting

policy for recognising revenue in respect of plots/ agricultural land including those covered under Agreement to sell entered into with subsidiary/ coordinating companies, from the year of registration of the sale deeds of the plots to the year of execution of the agreement to sell. Had the Company followed the earlier method of recognising revenue in the year of registration of the sale deeds of the plots, revenue would have been lower by Rs. 736.29 lacs, cost of revenue would have been lower by Rs. 373.03 and accordingly profits before tax would have been lower by Rs. 363.26 lacs. THIS CHANGE IN THE POLICY BROUGHT ABOUT AN OVER STATEMENT OF THE PROFITS BY 3.63 CRORES. Sobha developers a south Indian developer, changed its accounting norms in Q1 FY09 for revenue recognition, which facilitates revenue being recognised earlier in a project cycle. If the accounting policy had not been changed, the company's Q1 FY09 PBT would have been lower by 20%. "With effect from April 1, 2008, the company had changed its accounting policy for revenue recognition for sale of undivided share of land (group housing) on the basis of certain minimum level of collection of dues from the customer and/or agreement for sale being executed rather than criteria relating to the project reaching a significant level of completion to align it with revenue recognition policy for sale of villa plots. This has resulted in additional revenue recognition and higher profit before taxes of Rs 32.1 crore and Rs 15 crore respectively during the quarter ended June 30, 2008."

Exaggerate Accounts Debtors: Analogous to that of the exaggerated value of sales an attempt is generally being made to show higher level of debtors or account receivables. By exaggerating the debtors, companies try to report that they have additional cash that is receivable in the future, which enhances their financial position. A company overstates debtors by creating fictitious credit sales or by reduced provisioning for bad and doubtful debts. For instance, in the first quarter of 2009, Tata Motors changed its methodology for calculating provisions for doubtful receivables, which resulted in a higher reported profits of Rs 50.7 crore. Tata Motors transferred 24% stake in Tata Automotive Components (TACO), a company with revenue of $675 million in FY07, to Tata Capital, a group company, and booked a profit of Rs 110 crore in Q1 FY09. Management has declined to disclose the valuation methodology. Senior management of Tata Motors, in a conference call with analysts, said, "I would not be able to share with you the specific valuation methodology, except to say that the things are done by an independent reputed firm and based on the company's track record and future business opportunity." Tata Motors has also changed its methodology for calculating provisions for doubtful receivables, which resulted in higher reported EBITDA to the

extent of Rs 50.7 crore (10% of EBITDA). A change in the policy for doubtful receivables can bring about an enhanced EPS for the company. DLFs: non-DAL revenues declined 44% QoQ to Rs 2,250 crore and around 40% of sales have been to DAL, a group entity. 44% of debtors are DAL and of total debtors, the share of DAL has increased during the quarter, with DAL receivables increasing by Rs 1,450 crore Q-o-Q. During Q1 FY09, sales to DAL were Rs 1,560 crore, which is marginally higher than the increase in receivables from DAL. We would like to add that DLFs high level of transactions with group company DAL and high level of receivables has been a point of debate since it went public.

Deferring Expenditure: By excluding unpaid expenses or deferring them, a firm can easily reduce its liabilities. Accrued expenses tend to remain constant over a period of time, so this malpractice can be detected by checking for variations. A consistent decline in accrued expenses is also cause for concern. A change in the method of accounting for retirement benefits from accrual system to cash basis can suddenly increase the profits for a company. Many a corporate announce suddenly this decision of change from accrual to cash whensoever they intend to increase their profits. Prajay engineers Hyderabad-based developer, reported a loss in its fourth quarter results against expectations of a profit. The company "lost" records for a project worth 40% of its annual revenues at the site office. The company, in its press release, said - "After the year end, basic records relating to sale agreements/revenue and construction expenses of one of the projects of property development were lost at the site office, Vishakapatnam. The auditors in their report have stated that they were not able to verify the books and records relating to income of Rs 143.77 crore and relevant construction cost of Rs 75.26 crore. Management is making all efforts to locate/ retrieve the lost records." The principle of conservatism demands that any expected losses must be provided for. Whereas the expected profits/gains should not. However many a times many companies do otherwise.

Capitalisation Of Expenses: Current year expenses should be charged to the income statement of the current year only. Instead, some firms capitalise (spread out) and amortise these over a period of time. This reduces the current year expenses, thereby boosting profits. The interest on borrowings for purchase of assets before the start of production can be easily capitalised. However, even after the start of production companies do capitalise these interest expenses by deferring the reporting of production schedule. This instantly enhances the level of profits for the company.

Depreciation Policy: Depreciation is a non-cash expense but, it is deducted from a company's profits, reducing the net income. A company can inflate its net income by charging less depreciation on the assets. Arbitrarily increasing the life span of an asset or a change in the method of calculation can alter earnings and profits. For instance, Jet Airways changed its depreciation policy and wrote back Rs 920 crore into its profit and loss account, which helped it report profits during the first quarter of 2009. TCS too in 2010 increased the life span of its computers which resulted into lower depreciation as well as write back of the depreciation thus increasing the profits for the company. Change in the method of depreciation from WDV to SKM can easily increases the profits for the company. Jet Airways: changed its depreciation policy from WDV to SLM, and thereby wrote back Rs 920 crore into its P&L, which helped the company to report profits during a quarter. It also helped Jet to report a higher net worth, which will help in keeping reported gearing low. This is a one-time exercise. Jet Airways also capitalised forex loss of Rs 620 crore on forex debt and adjusted it against carrying value of fixed assets. TCS: the software major, increased its depreciation policy on computers from two years to four years. As a result, Q1 FY09 PBT was higher by an estimated Rs 50 crore (c.4% of net profit in 1QFY09). TCS follows cash-flow hedge accounting and till FY08, it used to recognise hedging gains on effective hedges in its revenue line, thus boosting the reported revenue growth and EBIT margin. In FY08, TCS had Rs 421crore from hedging gains, of which, Rs 137 crore was included in the revenue line. However, from Q1 FY09, TCS will report all forex losses/gains below the EBIT line in other income. Thus, the losses it had on its hedge position will no longer be booked in the operating line.

Capitalisation Of Foreign Currency Losses: Companies raise funds from abroad in the form of foreign currency convertible bonds (FCCBs). Investors have the option to convert these into equity after a stipulated period. FCCBs are treated as debt in balance sheets till these are converted into equities. These bonds are structured to allow a borrower to pay total interest and principal on maturity. If the value of rupee falls (vis a vis the other currency), the losses on such foreign exchange transactions go up. Companies understate their liabilities by not accounting for such losses in their income statements and including them in the balance sheet instead. In the first quarter of 2009, Reliance Communications did not include Rs 399 crore of losses on FCCBs. Similarly, many of the companies by not adhering to the AS 11 increased their profitability. With the rupee depreciation many of the company for the current quarter ending December 2011 are expected to project the price sensitive profit by capitalising losses from

currency fluctuations. These company shall absorb Forex losses by artificially inflating the value of plant and machinery that have been bought by foreign currency loan which has jumped in rupee terms. The decline in profit by using this mechanism shall be staggered over a period of time in the form of higher depreciation. Ministry of Corporate Affairs (MCA) has already helped this practice by offering a choice in implementing AS11 till 2020.

Foreign Exchange Fluctuation: Depending on the state of affairs of a company the recognition of foreign exchange rate at the time of transaction or the date of preparing the balance sheet. Most of the companies bring about this change of valuation to roseate the profit figures in annual reports. dr. reddy's had adjusted mark to market losses (Q1 FY08) on outstanding $250 million of hedges in the balance sheet, while P&L reflects forex gains realised. The company also reclassified its contract manufacturing business (CPS) revenues into API and Formulations, which makes it difficult to analyse its segmental performance. himatsingka in one derivative contract, had mark to market losses of $41.5 million as on March 24, 2008 and no provision was made, since the company had filed a case in court against the concerned bank. In case of another derivative contract, mark to market loss of Rs 158 crore as on June 30 had not been provided for, since the derivative contract was still open then. HCL tech has normally had a very large hedge position compared to its revenue base. While the rupee was appreciating, the company reaped benefits of this and reported $79.2 million in forex gains in FY07. The company has always maintained that it would prefer to lock-in a constant INR/US$ rate through hedging rather than suffer from currency volatility. However, the company unwound $540 million of hedges in June 2008 and booked large forex losses. Jaiprakash associates: did not provide for FX losses on outstanding FCCBs of $400 million through its P&L and plans to provide for the FX losses/ gains at the end of the year. Ranbaxy has mark to market losses of Rs 909 crore on forex derivative contracts, which they did not provide for because the company said that it believe, "the gain on fair valuation of underlying transactions against which the derivative transactions were undertaken amount to Rs 1,030 crore." This argument is against the principles of conservative accounting, wherein mark to market losses should be offset against assumed future profits. Reliance communications had adjusted short-term quarterly fluctuations in foreign exchange rates related to liabilities and borrowings to the carrying cost of fixed assets. The company adjusted Rs 109 crore of realised and Rs 955 crore of unrealised forex losses in the above manner. In addition, the company had not recognised Rs 399 crore of translation losses on FCCBs, since the FCCBs can

potentially get converted, although the FCCBs are out of money. Adjusted for all the above, the company would have virtually no profits in Q1 FY09 but had disclosed good amount of profits. Reliance Industries: in continuance of its policy, adjusted "foreign currency exchange differences on amounts borrowed for acquisition of fixed assets, to the carrying cost of fixed assets, which is at variance to the treatment prescribed in AS11." Had AS11 been followed, profits for Q1 FY09 would have been lower by Rs 940 crore (23% of reported net profits).

With all these policies manipulation underway it becomes highly difficult for an analyst or an investor to decipher the accounting reports. Here come an important role of the company directors to either nip the problem in bud by being extra vigilant or take corrective measures whensoever required to show the right picture.

A Board of Directors of a company is supposed to be in fiduciary relationship with the shareholders and therefore they are supposed to prevent the company from using deceptive accounting tactics that mislead investors. Any board member of any company knows that the goal of a company's board is to serve shareholders. However, wing to the fact that Board members continued existence depends on the maintenance of the support with the existing management these board members may be tempted to approve corporate policies that serve the company's executives or themselves rather than the company's shareholders. Consequently, they may be willing to ignore deceptive accounting practices.

A board is more likely to focus on serving the company's shareholders and ensuring proper accounting practices if there are independent board members serving on the board. If, an independent board member, rather than the chief executive officer of the company, is serving as chairman of the board, one can expect more reliability of the accounting reports. Furthermore, if a board with independent members is meeting more periodically one may expect better transparency of the accounting reports. These efforts allow independent members to develop their own opinions about the company without being completely influenced by the other board members. However, even if a board is stacked with independent members, it may still allow or even encourage deceptive accounting reports. Some board members are compensated in a manner that aligns their compensation with the short-term performance of the company. If a company uses fictitious accounting that inflates profit figures earnings and therefore inflates the company's value in the short term, board members may benefit directly and therefore,

shall obviously allow such actions. While many board members may not have taken a board position with the intention of deceiving shareholders, they may lack the initiative to force a change in management behaviour to show more accurate figures. A board member who is at odds with management cannot also be expected to retain his board seats. The easiest way to ensure that all board members have a unified goal is to ensure that their compensation from the company is tied to the long-term value of the company's stock rather than the annual profits.

Not all independent board members are effective monitors of a company's financial reporting. Some individuals are board members of several of companies and therefore do not have the sufficient time to closely monitor each company. Other board members do not have the ability to properly monitor the company's accounting, either because their experience is in another industry or because they do not have adequate accounting or financial skills. It might seem that this deficiency could be solved by ensuring that all board members have accounting backgrounds. However, a basic understanding of accounting will not necessarily enable a board member to detect deceptive accounting practices. Board members may need actual experience in accounting work to recognize many types of deceptive accounting practices generally adopted by corporate.

The use of a "generous" accounting method or deceptive reporting that will defer some of the expenses into next year, will result in a higher ROE. The company may not prefer to use the more accurate accounting method because, the main competitors use the more generous accounting method to determine their earnings.

Since, earnings measurements relative to competitors are commonly used by rating agencies, lenders, and analysts there is a tendency on the part of the directors to gloss over the under reporting of expenses and therefore exaggerating the profits. No company wants to be penalized simply because it provided a more precise measurement of its earnings.

The value of shares is positively related to earnings, so overstated earnings may result in an overvalued stock. If executives are aware that earnings are overstated, they can exercise their options and sell their shares. They have an incentive to exaggerate the earnings so that the stock price is temporarily increased and they can sell their stock holdings at a high price.

To be able to prevent excessive spending by executives and managers, the board of

directors may reduce the temptation for executives to use deceptive accounting. There would be no need for a firm to provide deceptive financial statements if the honest facts would satisfy investors. Basically, there are some ways for the board of directors to be able to prevent excessive expenses:

1. Initiate Or Enhance Increased Dividends – Since dividends represent cash outflows, they reduce the net cash flows that are available to the firm's managers. Thus, they can effectively discipline the managers' spending and may reduce waste. Since firms that pay dividends may have less excess cash, they may be less likely to waste funds. Conversely, firms that pay zero dividends may have more flexibility to use cash in ways that serve the managers more than the shareholders. Higher dividend payouts can also limit deceptive accounting by providing more information about the firm's cash flow situation. However, it must not be presumed that a firm's accounting is transparent just because the firm pays dividends. Many firms that pay dividends still engage in the deceptive reporting.

2. Use More of Borrwoings: – At times it is suggested that a firm that has periodic debt payments must be disciplined and use its cash properly so that it can make its debt payments. Debt is even more restrictive than dividends, because the creditors can force a firm into bankruptcy if it does not meet its debt obligations. A firm may signal its future cash flows when it decides to use debt financing. It would consider borrowing funds only if it expects to generate sufficient cash flows to cover its debt payments. Thus, its financial situation may be more transparent if it uses debt. However, firms that use debt financing may be enticed to inflate their reported revenue or deflate their reported expenses so that they can more easily qualify for credit. While investors may feel more secure knowing that a firm is being periodically monitored by its creditors, there have been many cases in which creditors were not able to detect a firm's financial problems before the problems were made public. It happened in the case of World com, Enron in US and in case of Satyam in India.

3. Allow The Firm To Become A Target –Weak firms are vulnerable to a possible takeover by stronger firms. A board may be able to prevent deceptive accounting and other unethical practices by allowing the firm to become a target that another firm can acquire. Such a strategy may force the firm's executives to make decisions that serve its shareholders. If the firm's executives make poor decisions, another firm (called a raider) may be able to buy the firm cheap, get rid of the ineffective executives, and improve the

firm. This renders benefits because it should be able to increase the value of this business by buying it cheap and improving it over time. Thus, a firm's executives are supposed to be concerned that if they do not satisfy shareholders, they will be replaced. If a firm's executives do not manage a firm properly and attempt faulty accounting gimmicks, they will be subject to the market for corporate raid.

4. Improve Monitoring – Executives and other managers commonly engage in activities that are not in the best interests of their shareholders. In some cases, the boards of directors approve these activities even though they are not in the best interests of shareholders. In other cases, the directors are not informed about the activities, either because they chose not to be or because they did not monitor the firm's executives and managers as closely as is necessary.

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