

Literature Review on Earnings Management

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ABSTRACT

With the increasing degree of marketization of China's economy, the quality of corporate accounting information has attracted more and more attention. The distortion of accounting information interferes with the national economic order and impairs the optimal allocation of resources in the securities market. As an important factor affecting the distortion of accounting information, earnings management has also received much attention. This article first sorts out relevant literature at home and abroad to define the concept of earnings management, and then puts forward some suggestions and enlightenment for China's enterprise reform in view of the current situation of earnings management in listed companies in China. The article has certain reference value for improving the efficiency of corporate governance and deepening enterprise reform.

KEYWORDS

Corporate Governance; Real Earnings Management; Accrual Earnings Management

1. INTRODUCTION

Earnings management is one of the main methods we use to measure the quality of accounting information. To a certain extent, accounting information reflects the financial situation, operating performance and cash flow of economic entities. It is an important basis for governments, shareholders, management and other stakeholders to make economic decisions, and it is also one of the factors affecting the pricing efficiency of securities and their derivatives in the capital market. As an interesting research perspective, earnings management has been extensively studied by scholars at home and abroad in recent years. They try to explain the motivations of earnings management from various angles and explore what governance impacts earnings management will have on enterprise management. After decades of research, scholars have made many innovative research conclusions. In order to sort out these research conclusions, this paper attempts to review the relevant research on earnings management from the perspectives of accounting information quality, initial public offering, executive power and compensation, equity incentives, taxation, etc., so as to provide a reference for in-depth research on earnings management.

2. OVERVIEW OF EARNINGS MANAGEMENT

2.1. Classification of Earnings Management

Shleifer found that the fundamental motivation behind management manipulating earnings through accruals is to seek personal gains, such as increasing on-the-job consumption, enhancing prestige, and consolidating their position. For management to pursue private benefits through control, it must occur in an environment of information asymmetry. Within a company, management holds actual

control and possesses both the motive and the means to manipulate earnings for personal benefit, even though this could severely damage the firm's value in the long term. Accrual-based earnings management by executives constitutes an expropriation of the interests of external investors; such behavior is ethically condemnable and legally punishable. Therefore, when faced with the lure of benefits and the risks involved, management aims to strike a balance between costs and rewards in their decision-making. Chen Jun and Zhang Chuanming (2010) [1] found that as the information environment of firms improves, management will face greater risks when engaging in misconduct, and after weighing the costs and benefits, they will reduce accrual-based earnings management activities.

In academia, the behavior of misleading stakeholders by manipulating actual operational, financing, and investment activities to achieve personal gain is referred to as real earnings management. Since Roychowdhury published his seminal work on real earnings management, many subsequent researchers have adopted his model. This model estimates the magnitude of real earnings management using indicators such as abnormal operating cash flows, abnormal expenses, and abnormal production costs, which align more closely with actual business operations. Although real earnings management can be statistically measured, it often occurs within the expense consumption of specific business activities and is therefore more concealed and harder to detect in financial statements. Lin Yongjian et al. (2013) [2] and Deng Lu et al. (2019) [3] believe that, compared to accrual-based earnings management, real earnings management causes greater harm to companies.

2.2. Motivations for Earnings Management

Capital market motivation refers to earnings management conducted by corporate management with the aim of achieving objectives such as an initial public offering (IPO), additional share issuance, rights offering, bond issuance, avoiding losses to remove special treatment status, or influencing the company's stock price, in order to raise more capital from the market, obtain higher returns on capital, accomplish acquisitions, or meet the expectations of securities analysts or investors. Earnings management driven by capital market motives can be classified into malignant and benign types. Malignant earnings management often crosses the bottom lines of accounting standards and business ethics to manipulate financial figures, which may satisfy the short-term interests of management but will eventually face legal sanctions. In contrast, benign earnings management stays strictly within the boundaries of accounting policies and business ethics. It conveys stable earnings information to the capital market through moderate earnings adjustments to stabilize or increase the company's stock price and reduce operational risk. Benign earnings management includes four approaches: accounting, financial, operational, and strategic. Accounting earnings management involves the use of fair value measurement, provision for bad debts, capitalization of R&D expenditures, and estimated liabilities. Financial earnings management is achieved by rational planning of financing, investment, and distribution activities to produce expected results in financial statements. Operational earnings management involves appropriate arrangements in transaction methods, pricing, and mergers to reflect anticipated outcomes. Strategic earnings management is carried out through comprehensive strategic planning, supplemented by the selection of accounting policies, operational models, and financial arrangements. Lin Zhizhang and Huang Xingluan (2019) [4] pointed out that companies have incentives to manage earnings during the IPO period to ensure a successful listing. Zhang Yan (2018) [5] found that companies primarily rely on accrual-based earnings management to adjust financial reports at the early stage of the IPO process. As the IPO waiting period extends, earnings management gradually shifts toward real activities. Jiang Qiuju and Li Danmeng (2018) [6] believed that firms with continuous dividend payouts are motivated to smooth earnings through both accrual-based and real earnings management. When earnings increase compared to the previous year, such firms are more likely to engage in negative earnings management, with this tendency being more pronounced in state-owned enterprises.

In China, according to securities regulations, listed companies that incur losses for two consecutive years will be subject to special treatment (ST), and those that experience losses for three consecutive years will face suspension of listing. If they are unable to return to profitability within a specified period and no longer meet the listing requirements, the stock exchange may directly decide to delist the company. Once a company is placed under special treatment, it becomes more difficult to obtain financing. Suspension or delisting also means the loss of valuable shell resources, thus giving management a strong incentive to engage in earnings management to avoid reporting losses. Wu Liansheng, Bo Xianhui, and Wang Yaping (2007) [7] estimated and compared the extent of earnings management between listed and unlisted companies using the earnings distribution method, and found that from 1998 to 2004, both listed and unlisted companies in China engaged in earnings management to avoid losses each year. Among them, listed companies showed a higher frequency and greater magnitude of loss-avoidance earnings management than unlisted ones. Regarding the behavioral patterns of earnings management in loss-making firms, Lu Jianqiao (1999) [8] studied 22 loss-making companies listed on the Shanghai Stock Exchange and found that they tend to increase earnings in the year prior to their first reported loss in order to avoid reporting a deficit, and reduce earnings in the year of the first loss to avoid consecutive losses. Zhang Xin and Yang Zaihui (2007) [9] had similar findings and pointed out that items such as cost of main operations, administrative expenses, investment income, and non-operating income and expenses are relatively easy to manipulate. In a study on the earnings management behavior of loss-making listed companies in the fourth quarter, Zhang Xin (2008) [10] found that if the company has a chance of turning losses into profits within the year, it will increase earnings in the fourth quarter to achieve profitability; if there is no hope of turning around the loss that year, the company will instead increase the loss in the fourth quarter in preparation for achieving profitability in the following year. Wei Tao, Lu Zhengfei, and Shan Hongwei (2007) [11] studied the motivations behind the use of non-recurring gains and losses for earnings management by listed companies, and found that loss-making companies mainly use this method to turn losses into profits and avoid losses, while highly profitable companies tend to use it to smooth earnings and avoid profit declines.

3. FACTORS INFLUENCING EARNINGS MANAGEMENT

Gunny (2010) [12] found that prior to the enactment of the Sarbanes-Oxley Act, corporate managers primarily relied on accrual-based earnings management to manipulate accounting profits, and as the enactment of the Act approached, accrual-based earnings management showed an increasing trend, while the intensity of real earnings management remained at a relatively low level. However, this distribution pattern underwent a sharp reversal after the Act was passed: the intensity of accrual-based earnings management declined dramatically, whereas the intensity of real earnings management rose significantly. These results suggest that external legal factors have a significant impact on managers' choice of earnings management methods. In order to evade regulation, managers tend to opt for real earnings management, which is more difficult to detect.

Internal corporate governance mainly refers to the impact of the board of directors on managers' real earnings management behavior. Beatriz et al. (2008) [13] found that the greater the number and proportion of independent directors on a company's board, the lower the intensity of real earnings management. Bushee (1998) [14] discovered that institutional investors have a significant restraining effect on the intensity of real earnings management. Cheng showed that compensation committees are capable of detecting managers' real earnings management behavior and can adjust their compensation accordingly. These findings indicate that corporate governance factors such as the board of directors and external shareholders can significantly influence managers' real earnings management activities.

From the above literature by foreign scholars on the influencing factors of real earnings management, it is evident that the main influencing factors include: the strength of supervision by external

regulatory agencies, and the soundness of internal corporate governance. Under the special macro-legal environment in China—where the capital market’s legal system is still underdeveloped, supervision is insufficient, enforcement tools are outdated, and penalties are weak—along with the unique corporate governance structure characterized by dominant shareholders, whether and how various internal and external factors affect real earnings management in Chinese companies remains a valuable topic for further research.

4. CONCLUSIONS

Domestic and international scholars have conducted in-depth research on earnings management from various perspectives, forming distinct theoretical systems. These studies provide abundant empirical tests and practical analyses on the causes and impacts of earnings management, which greatly help users of financial reports better understand publicly disclosed accounting information. The causes and impacts of earnings management mainly include the following aspects: The occurrence of earnings management undoubtedly damages the reliability of accounting information; meanwhile, strengthening the regulation of accounting information disclosure can inhibit earnings management behaviors. During initial public offerings (IPOs), companies and shareholders have incentives to engage in earnings management to attract investment and reduce agency problems. Management’s pursuit of satisfactory compensation is an important motivation for earnings management, while appropriate compensation incentives can curb such behavior. For controlling shareholders, earnings management can serve as a means to appropriate benefits from management and minority shareholders. Lastly, related stakeholders of the company may engage in certain earnings management for tax avoidance purposes.

In summary, earnings management has long been a research hotspot and is expected to continue so. However, the abundance of research has caused scholars to focus repeatedly on a few aspects, making it difficult to delve deeper or discover new viewpoints. This has led to relatively few earnings management articles published in top international journals. It is foreseeable that future research on earnings management still has many areas to explore and improve.

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