

# ***Study on Earnings Management Methods And Influencing Factors of Listed Companies in China***

**ZeJia Weng<sup>1,a,\*</sup>**

<sup>1</sup>*School of Accounting, South-western University of Finance and Economy, Chengdu, China,  
611130*

*a. ZEJIA.WENG@BARUCHMAIL.CUNY.EDU*

*\*corresponding author*

**Abstract:** With the further development of China's capital market, the importance of earnings management has gradually become one of the key research topics in the accounting field. Starting from the basic concept of earnings management, this paper mainly studies the motivation, means and influencing factors of earnings management of Chinese listed companies. Through the review and sorting of the relevant literature, the conclusions and suggestions are given at last. This paper argues that supervision for earnings management of Listed companies still needs to be strengthened in China. Based on the study of earnings management of Chinese listed companies, this paper hopes to put forward some suggestions to better improve the securities market environment, improve the capital market system and standardize the financial information disclosure of listed companies in China.

**Keywords:** Listed Companies, Earning Management, China, Influence Factor.

## **1. Introduction**

Earnings management is an important means for enterprises to obtain more favorable resources in the capital market. It has been studied by western academic circles for a long time. However, earnings management research in China started relatively late, because of the slow development of market regulation. With the emergence of financial fraud scandals in listed companies in China, earnings management has gradually become a hot research issue. In order to prevent the destruction of the capital market and the damage to investors' interest, how to govern the earnings management behavior of listed companies has become an important issue concerned in China and other countries. In recent years, many researchers have made numerous pieces of literature on the influence of earnings management on the financial situation of listed companies. Therefore, this paper will comb related research papers, and conduct an analysis on influencing factors of earnings management. By analyzing the means and influencing factors of earnings management of listed companies in China, this paper obtains the countermeasures of earnings management for listed companies. This paper puts forward some suggestions for strengthening the supervision of earnings management behavior of listed companies and provides a theoretical basis for further research.

## **2. An Overview of the Earnings Management**

### **2.1. Basic Theory of Earnings Management**

Earnings management is management means that the enterprise management authorities intervene and whitewash the financial information such as enterprise financial reports in various legal ways for the purpose of maximizing their own interests or enterprise value[1]. Earnings management has three main characteristics. First, the final released earnings may be the comprehensive results of earnings management by the board of directors and managers respectively. The separation of property rights leads to different purposes of earnings management between the board of directors and managers. The board of directors aims to increase the market value of the enterprise, while the managers aim to increase their own utility. Second, in a long enough period, adjusted profits through earnings management will not change the actual earnings of the whole company, but only change the different distribution of the total actual earnings of the company in the accounting year[2]. Third, earnings management should be a legal behavior within the scope of accounting standards and relevant laws and regulations. Listed companies flexibly use accounting and non-accounting tools to legally redistribute the actual earnings over the company's fiscal years. Earnings management can be divided into accrual earnings management and real earnings management according to the differences in the means used and the economic consequences. Accrual earnings management is based on accounting standards. It uses accounting policies or accounting estimates to affect the level of earnings disclosed in the financial reports of each period, does not change the cash flow, and does not affect the total earnings in the long run. Real earnings management is realized by arranging real transactions, that is, corporate managers conduct earnings management by constructing specific transactions and controlling the timing of transactions[3]. This type of earnings management usually affects both earnings and actual cash flows in each period. In the process of operation and management of listed companies, both kinds of earnings management are often used at the same time.

### **2.2. The Motivation of Companies' Earnings Management**

There are many reasons for enterprises to conduct earnings management. Through reviewing the existing literature, this paper summarizes that there are mainly four reasons:

#### **2.2.1. Motivation for Managers' Compensation**

In the modern enterprise system, enterprise managers have a high status. In the actual process of production and operation in an enterprise, the operator has the right of control over the enterprise. In this case, management compensation is closely related to enterprise performance, while accounting information directly reflects enterprise performance. Therefore, managers will try to achieve the desired effect through earnings management for the benefit of the enterprise or their own.

#### **2.2.2. Motivation of Tax Avoidance**

The enterprise management always hopes to pay as little income tax as possible, so the accounting profit as the tax base of enterprise income tax has become the object of management operation adjustment. Some earnings management practices to defer profits or reduce earnings can not only reduce the tax that enterprises need to pay, but also may lead to the government to take measures to subsidize enterprises[4].

### **2.2.3.Motivation of Debt Contract**

The corporation's limited liability system makes the shareholders only have to bear limited liability when the investment fails, while the creditors have to bear all the consequences of the investment failure. This puts creditors at a disadvantage compared with debtors. In this case, to protect their own interests, creditors will ask the debtor to produce a financial statement before borrowing money. In addition, the creditor will set up a series of protective clauses in the debt contract. Debtors who violate these terms can face loan repossession and restrictions on their business activities. In this context, in order to successfully borrow debt and not violate relevant terms during the debt period, enterprises will carry out a series of earnings management activities to achieve the purpose of satisfying creditors. [5].

### **2.2.4.Motivation of Policy**

Due to the influence of China's special economic system, the government has a high degree of intervention in the market. Resulting in many enterprises, especially those in the financial and ridge industries, being generally sensitive to the political cost. Forced by high administrative costs, these enterprises will operate to reduce or avoid the purpose of political costs. For example, heavily polluting industries are often subject to special "tariffs" imposed by social associations and government departments. This may impose additional tax burdens on enterprises or lead to industry regulation. In order to avoid political costs, corporate management will deliberately implement earnings management[6].

## **3. Methods of Earnings Management of Listed Companies**

### **3.1. Earnings Management Status of Listed Companies in China**

Most of the earnings management behaviors of listed companies in China are in response to the behavior of bond companies. From a global perspective, China's listed companies are quite different from their foreign counterparts in earnings management and audit, corporate governance and other aspects. At present, the analysis of earnings management means in China mainly focuses on whether independent audits can identify earnings management, but this is very different from the application of earnings management behavior in practice[7]. At present, there are still many problems in the earnings management of listed companies. This paper will simply elaborate on the following aspects:

#### **3.1.1.Irregularities in Related Party Transactions**

Related party transaction is also a common means of earnings management of listed companies, which is often not standardized. In daily business activities, listed companies often have various transactions with their related parties, including purchase and sale business, agency and leasing. For parent and subsidiary companies, higher or lower trading prices are often used as needed. This kind of non-standard related party trade damages the legitimate rights and interests of stakeholders, which is another malpractice of earnings management of listed companies[8].

#### **3.1.2.Lack of Sound Governance Institutions**

In earnings management of listed companies, the distribution of rights and interests among Since the implementation of new accounting standards in 2007, many contents of accounting management of listed companies in China have changed greatly, which has promoted the financial information management of listed companies in China to become more institutionalized and scientific. But at present, the government's supervision of the securities market lacks of perfect laws and regulations

management, especially the accounting treatment standards of its new projects are not perfect. This results in the existence of earnings management in some listed companies in China, which greatly degrades the authenticity and reliability of earnings information[9].

### **3.1.3.Lack of Effective Incentive Mechanism**

Most listed companies in China generally lack effective measures in incentive mechanisms. As a result, enterprises cannot effectively supervise and limit the responsibilities and rights of accounting and other personnel. It is hindered the improvement of business efficiency and performance.

## **3.2. Analysis of Earnings Management Methods of Listed Companies**

### **3.2.1.Earnings Management by Related Party Transactions**

Related party transaction refers to the exchange and transfer of various materials between enterprises and related enterprises, and some transactions are unfair. As there are a lot of listed companies in China that are separated from the original state-owned enterprises, there are extremely complicated relations between them, which provides opportunities for related party transactions.

Firstly, they can use transaction price to realize profit transfer. Transactions between related parties are usually carried out without fair value, and usually follow the principle of agreed price due to the existence of control relations. The listed company can set the price according to its own demand. When the profit level is low, it can purchase the products of the affiliated enterprises at a low price or sell the products to the affiliated enterprises at a high price, so that the profits flow from the affiliated enterprises to the listed company and realize the profit transfer.

Secondly, they can transfer the costs to release the burden. In many cases, there is the problem of cost allocation between the related parties, which should be allocated according to the reasonable standard of allocation. However, in order to achieve a special purpose and improve their earnings, the listed company may reduce or exempt the management fees payable by the parent company, and turn to the parent company to bear the management fees and other expenses that should be borne by the parent company. This reduces the cost burden of listed companies and realizes the transfer of costs and profits.

Thirdly, they can use capital flow to transfer profits. The relevant regulations clearly state that funds cannot be borrowed from each other between enterprises, but there is no clear statement about the occupation cost problem, which gives enterprises more opportunities. At the same time, there are often business contacts between enterprises, occupying funds is inevitable, which gives listed companies the space for earnings management. When the profit level of the listed company is low, the listed company will not pay the occupancy fee, and even the parent company will return the occupancy fee paid by the listed company in the past, thus improving the surplus level of the listed company and realizing the profit transfer.

### **3.2.2.Earnings Management by Using Accounting Policies and Estimates Changes**

According to the provisions of the accounting law, once the accounting policy starts to be used, it cannot be arbitrarily changed. However, China's accounting policy change threshold is not high, so that some enterprises obtain additional profits through the change of policy. Accounting estimation is the company to determine the outcome of uncertain events, which has strong flexibility. Earnings management means using accounting policies and accounting estimates are mainly carried out in the following ways:

The first one is earnings management by asset impairment. According to the provisions of accounting standards, the enterprise has a clear time limit for the impairment test of the assets, in the

test to reasonably estimate the possible loss, the provision of assets impairment. In this process mainly based on the professional judgment of accountants, listed companies with a low level of profit less provision for impairment, so that can increase the profit of the accounting period; When the profit is high, more impairment provisions can be made to prepare for less provision in the next year.

The second one is changing the depreciation policy of fixed assets to make earnings management. Accounting standards stipulate that enterprises should review the depreciation method, service life and estimated net residual value of fixed assets every year, and make adjustments according to the actual situation. Because the amount of fixed assets in enterprise assets is usually large, the change in its depreciation policy will have a certain impact on the company's profit. Therefore, changes in depreciation methods and extension of service life of listed companies may lead to changes in current and future accounting earnings.

The last one is the consolidated statement prepared by the parent company and includes all subsidiaries under its control. It reflects the situation of the group as a whole. If a listed company wants to exclude one of its subsidiaries from the consolidated statements, it can sell, transfer or reduce its shares. In order to include the subsidiaries that are not included in the consolidated statements, the investment proportion can be increased or the acquisition can be adopted. Consolidated profit can be increased or decreased by changing the scope of consolidated statements.

### **3.2.3. Earnings Management Using Asset and Debt Restructuring**

Assets reorganization is a process of asset recombination and allocation in order to optimize industrial structure and realize industrial perfection. Debt restructuring is a matter in which creditors make decisions to reduce their profits according to an agreement with the debtor or a court ruling when the debtor suffers an economic crisis. When a listed company is in trouble, its stakeholders often transfer profits through unfair transactions and make concessions in the name of the asset or debt restructuring, in order to support the company. There are mainly the following ways:

At first, through related party transactions, the non-performing assets and liabilities of listed companies are removed and transferred to related party enterprises, so as to eliminate adverse effects.

Second, listed companies can replace non-performing assets with the good assets of related non-listed companies, in order to increase the market value of the company.

Last but not least, listed companies acquire high-quality assets with strong profitability of unlisted companies at a low price to achieve the purpose of asset restructuring.

## **4. Analysis of Influencing Factors of Earnings Management**

### **4.1. Influencing Factors of Earnings Management**

The factors influencing earnings management of listed companies in China are mainly divided into two aspects, internal and external. The internal factors include internal control, comprehensive quality and post-competency of managers. On the other hand, the external factors contain government regulation and good information disclosure. The followings are the detailed analysis and suggestions.

### **4.2. The Influence of Internal Control of Listed Companies on Earnings Management**

Internal control is beneficial to standardize accrued earnings management and reduce real earnings management. Internal control of listed companies provides a guarantee for the authenticity and reliability of financial statement information and the legal compliance of the company's production and operation activities. The existence of the internal control can not only make the accounting standards for listed companies suitable with their own actual situation that isn't detailed or perfect but also effectively estimate changes, such as policy choice of financial practitioners subjective behavior

limits and the correct guidance, to prevent the related professionals' abuse of accounting policies and accounting estimates[10]. At the same time, the internal control on the basis of the financial accounting standards, perfect the listed company is reported to the world of information processing procedure and normative. When financial personnel to the same business process change or make changes to the original estimate, the reason must be listed in the results note as well as the impact on the performance, in order to ensure the quality of earnings.

Besides, internal control is conducive when internal control runs through the whole process of production and operation of listed companies. One of its functions is checks and balances and supervision among various posts. The existence of internal control of listed companies enhances the ability to identify real earnings management, reduces the invisibility of real earnings management, inhibits the real earnings management behavior that is detrimental to the long-term value of listed companies, and is conducive to promoting sustainable development ability of listed companies. Therefore, internal control is conducive to reducing real earnings management, reducing the risks that listed companies will face due to real earnings management and promoting the long-term healthy development of listed companies.

### **4.3. Governance for Earnings Management of Listed Companies in China**

The Chinese government and external regulatory agencies need to further improve their respective functions, in order to jointly promote the healthy development of China's listed companies. In view of the differentiated development of earnings management, this paper makes a brief analysis from the following aspects.

#### **4.3.1. Strengthen Supervision and Punishment**

First, we need to improve our regulatory approach. From the perspective of the CSRC, listed companies are required to disclose their own earnings quality indicators and other key information. For example, in financial reports, the net cash flow generated by operating activities per share must be disclosed in accordance with relevant national regulations and interpreted with indicators. Among them, some major acts should be fully disclosed, such as mergers and acquisitions, asset restructuring, policy changes, asset transactions, etc., must be disclosed because these behaviors will have a huge impact on enterprise operations. Second, increase the severity of punishment. For example, accounting information distortion of listed companies, especially audit fraud, must be severely punished.

#### **4.3.2. Constantly Improve Information Disclosure in Light of the Actual Situation**

First, from the perspective of maximizing the protection of legitimate rights and interests of investment, we urge listed companies to fully disclose relevant information. It should also be subject to the comprehensive supervision of the public, the media and the securities market. For listed companies, the quality of information disclosure should be strictly examined, and the focus of the audit should be the sustainable profitability of the enterprise. Second, strengthen the improvement of the Regulations on The Supervision of Listed Companies, and timely amend the Measures for the Administration of Stock Exchanges in light of the actual situation. It is necessary to constantly improve other provisions such as stock Listing Rules, which can improve the phenomenon of information asymmetry to a certain extent.



## 5. Conclusion

This paper reviews the factors influencing the earnings management behavior of domestic listed companies. Earnings management is a double-edged sword that needs to be controlled correctly. Once there is any deviation, it may develop into profit manipulation, and the consequences will be unimaginable. For listed companies, they should not only improve managers' comprehensive quality and job competency, improve the internal control system, but also establish an internal information communication platform and attach importance to the role of internal audit supervision. Externally, it is necessary to strengthen the supervision and management role of external audit institutions and relevant government departments and severely punish violations of laws and regulations. In order to optimize internal control, curb earnings management, and then promote the healthy and sustainable development of listed companies, maintain a good financial market order. However, this paper does not carry out an in-depth analysis of differentiated earnings management in specific industries. Future research can focus on these aspects.

## References

- [1] JinWei Bai. *Listed companies earnings management behavior study [J]. Journal of cooperation in economy and technology*, 2021 (23) : 154-155. The DOI: 10.13665 / j.carol carroll nki hzjjykj. 2021.23.063.
- [2] DongPei Zhan. *Thinking and analysis of the listed company earnings management [J]. Market modernization*, 2022 (6) : 148-150. The DOI: 10.14013 / j.carol carroll nki SCXDH. 2022.06.051.
- [3] Qin Li, WenYao Li. *On the Means of real Earnings Management and Its Preventive Measures [J]. Times Economics and Trade (the last ten days)*, 2007(06):136-137+139.
- [4] HaoWei Wang. *The definition, motivation and normative measures of corporate earnings management behavior [J]. China Management Informatization*, 201,24(18):25-27.
- [5] Min Wang. *Research on the impact of external audit on earnings Management of listed Companies [J]. Commercial Accounting*, 2022(03):66-69.
- [6] Zhu Zhikang. *Discussion on earnings management of Listed Companies in China [J]. China Collective Economy*, 2022(02):86-87.
- [7] ZhenZhen Rao. *Earnings management of listed companies means differences to explore [J]. Modern marketing (the last ten days)*, 2020 (4) : 57-58. DOI: 10.19932 / j.carol carroll nki. 22-1256 / f 2020.04.032.
- [8] ZhiZeng He. *Earnings Management of listed Companies under the background of new accounting Standards [J]. Shanghai Commerce*, 2021(12):156-158. (in Chinese)
- [9] YuMin Yang. *Earnings Management of listed Companies under the background of new accounting Standards [J]. Shanghai Commerce*, 2021(09):134-135. (in Chinese)
- [10] Chang Li. *Internal control and earnings management of listed companies research [J]. Journal of cooperation in economy and technology*, 2021 (9) : 132-133. The DOI: 10.13665 / j.carol carroll nki hzjjykj. 2021.09.054.