

Study on Related Issues of Earnings Management for Listed Companies in China

Zhihao Su

Langfang Teacher's College
LangFang HeBei China
e-mail: Heavencolour_00@163.com

Yajuan Chen

Langfang Teacher's College
Langfang HeBei China
e-mail : 787948854@qq.com

Abstract—Earnings management has been existed for a long time in the West, which has also been widely concerned by the accounting profession in China in recently years. The earnings management of listed companies has become the focus of investors, creditors, competent public authorities and the institutions that set up accounting standards. China's enterprises have large number of actions for earnings management, which are presented in diversified and complicated form. This paper mainly discusses about the earnings management of listed companies in China through the motives of earnings management and currently adopted methods of earnings management.

Keywords- earnings management; listed companies; related party transaction

I. INTRODUCTION

The earnings management has been existed in western countries for a long time, which has also been widely concerned by the accounting profession in China in recent years. The rapid development of stock market demands for high-quality accounting information of listed companies, which makes the earnings management of listed companies as the focus of investors, creditors, competent public authorities, as well as institutions that set up accounting standards. China's enterprises have large number of actions for earnings management, which are presented in diversified and complicated form. Informal earnings management acts have reduced the quality of accounting information for the listed companies, misled the investment decision-making of information users, and affected the investment confidence of investors, as well as the long-term and stable development of the stock market. Meanwhile, it has damaged the whole interests of the country, the interests of minority shareholders and the interests of creditors.

A. *Meaning of Earnings Management and Current Status of Earnings Management for Listed Companies in China*

1) *Meaning of earnings management* :Domestic and foreign scholars have not reached common agreement with regard to the meaning of earnings management, but most scholars maintain that earnings management is the action that the enterprise management authority makes the reported earnings reach to the expected standards in order to obtain certain private interests. Moreover, it is achieved under the restriction of accepted accounting principle, and through

selecting the most preferable accounting policies or controlling the accounted items.

Therefore, we come to the following conclusion: (1) the subject of earnings management is the company management authority; (2) the object of earnings management is the reported earnings (namely accounting income); (3) the method of earnings management usually refers to the option of accounting policies; (4) the direct target of earnings management is the influence on accounting information users' understanding to the performance of business operation; (5) the final target of earnings management is the maximization of personal interests or enterprise value.

2) *The Current Status of Earnings Management for Listed Companies in China* : In recent years, with the gradual development of the stock market in China, the earnings management is becoming more and more popular in listed companies, and it is presented in a diversified and complicated form. As the continuous revision and perfection of accounting standards, the earnings management methods of listed companies is also weeding through the old to bring forth the new. Because of the objective conditions such as lagged accounting standard, the unique corporate governance structure, the accounting subject's low demand for real accounting information level, and absence of external restrictions, the corporate management personnel can manipulate the paper profit to blind the market through the ways different from that of western countries. Therefore, strengthening the study on earnings management of listed companies is significant for enhancing the accounting information quality of listed companies and improving the optimum resource distribution of the stock market.

II. MAIN OPERATION METHODS FOR EARNINGS MANAGEMENT IN LISTED COMPANIES

A. *Related Party Transaction*

1) *Earnings management through merchandise trading and labor service*: Because the asset stripping before appearing on the market is not complete, the horizontal competition between the stock companies and group companies is universal. Therefore, there are large number of related party transactions in raw materials purchasing and product sales business. The pricing is the key in related party transaction. In our country, the common way lies in that: in order to support listed

companies, the group companies often provide raw materials to listed companies at a price that lower than the internal price of market price, while purchase outright and underwrite the products of listed companies at a higher price. Then, it transfers the difference of prices to listed companies by making use of raw materials supply channel and product sales channel.

2) *Earnings management through management on a commission basis or trustee management* : In current stock markets in China, because lacking of regulations, provisions, and operation rules for trustee management, the trustee management has become a method for earnings management of listed companies. It mainly manifests in the following aspects: (1) the listed companies entrust the non-performing assets to parent companies, and collect certain amount of retaliation, so that the listed companies can avoid the financial loss of non-performing assets and obtain certain profit without foundation; (2) the parent company entrusts the assets with stable and high profit-making capacity to listed companies through in the low-income way, and it is directly charged to the interests of listed companies.

3) *Earnings management through transferring expense burden* : When joint-stock company is reorganized to get listed on the market, we usually strip the unproductive capital of enterprises burdened with social responsibilities. And when the stock company gets listed on the market, it still needs certain services from related party companies. Therefore, before appearing on the market, all parties have to sign agreements about payment and cost-sharing standards of related expenses, including medical treatment, diet, and nursery, houses for employees, advertising expenses, and expenses for retirees. The fund flow that brought by these items is one of the main contents for related party transactions of listed companies.

4) *Earnings management through fund flow* : According to concerned laws and regulations, call loans between enterprises are not allowed. But in fact, the fund flow between the listed company and related party company is common. The listed company helps the related party company to pay for partial fund through collecting expenses for using government funds, which can increase the profit of listed companies on one hand, and help the related party company to get required funds on the other hand.

5) *Earnings management through asset and debt restructuring*: In order to achieve the purpose of earnings management, the listed company usually replaces the non-performing assets as the excellent assets of related party company. Through asset replacement, the listed company can increase its profit, which is mainly embodied in the following aspects: (1) exchange one batch of fixed asset with another batch of fixed asset; (2) the listed company exchanges its affiliated company or subsidiary company with that of parent company; (3) the listed company exchanges its fixed asset through the affiliated company or subsidiary company of parent company.

B. *Earnings Management through Accounting Policy and Change in Accounting Estimates*

1) *Change depreciation method and period of depreciation*: The change of depreciation method and period of

depreciation can directly influence the corporate profit. With regard to the depreciation method of fixed assets, it changes from the accelerated depreciation method to the straight-line method (in the early period of the fixed asset service). The period of fixed asset service life is extended. All of these may correspondingly increase the profit at the current period and in the future.

2) *Change the business accounting method of long-term equity investment* : The business accounting of long-term equity investment can be divided into equity method and cost method according to the influences on invested companies. The characteristics of equity method are: no matter the invested enterprise is distributed with profit or not, the invested enterprise should confirm the profit or loss according to the profits or losses, as well as the investment proportion of the enterprise. And these are calculated in the total profit at the current period. However, under the cost method, only when the invested enterprise is distributed with profit, can the received profit be calculated into the gains on investments at current period, without considering the actual profit or loss of the enterprise.

3) *Change the inventory pricing method* : Different inventory pricing methods impose different influences on the financial position and profits or losses of the company. Meanwhile, its influences on the profit and loss accounting are as follows: (1) if the pricing for closing inventory is too low, the profit at current period may decrease accordingly; (2) if the pricing for closing inventory is too high, the profit at current period may increase accordingly; (3) if the pricing for initial inventory is too low, the profit at current period may increase accordingly; (4) if the pricing for initial inventory is too high, the profit at current period may decrease accordingly. Because the closing inventory of current period is the initial inventory of the next period, and if the inventory pricing method keeps the same, it may have little influence on the profit and loss of the company. But if the pricing method is changed, it may influence the profit and loss of the company, thus becoming a method for earnings management.

C. *Advance or Delay the Confirmation of Income and Expenses*

The income should be confirmed and recorded after finishing the earning process and the transaction. According to the requirements of earnings management, enterprise management personnel may confirm and record the income before the earning process and the transaction, so as to increase the income at current period. Or they may also delay the confirmation of income, so as to decrease the income at current period, or smooth the profit.

When enterprise management personnel find that the surplus of the current year cannot meet the needs, they may delay the confirmation of expenses to the next year, while which may be done at the current year. Or they may advance the confirmation of expenses in next years to the current year, so as to lay foundation for enhancing the profit of next years.

III. SUGGESTIONS TO GUARD THE ACTS OF EARNINGS MANAGEMENT

A. *Strengthen Internal Control, Consummate Corporate Governance Structure*

1) *Optimize shareholding structure, cultivate institutional investor, solve vacancy issue of owners:* For the state-owned stock rights of “absolute ration share” in the capital market, “vacancy of owners” is the main reason for poor governance of listed companies. In the meantime of reducing the state-owned shares, the team of institutional investors may be expanded, to form the shareholders with the ability of supervision. These shareholders can participate in the decision making of the company, effectively supervise the management level of the company, and control the acts of earnings management.

2) *Introduce independent director system, strengthen the supervision on operators, and promote the effective operation of board of directors:* In order to strengthen the supervision on the board of directors, and protect the profit of minority shareholders, restraint mechanism for the manager level and large shareholders is taken into shape, so as to strengthen internal control. In terms of the corporate governance structure, external independent board is brought in, and also independent audit committee is established. The audit committee is authorized to employ external auditors, and maintain the independence of external auditing.

3) *Change the salary pattern of managing agent, and establish effective incentive mechanism for managing agent:* China’s listed companies should change the salary pattern of managing agent, to establish the salary pattern that combines the short-term incentives that based on accounting information with the long-term incentives that based on enterprise market value. Adopt the incentives such as annual salary system and stock options to avoid short-term earnings management for the managing agent.

B. *Strengthen on-the-job Training and Professional Ethics Construction for Accounting Personnel*

At present, the current status of ability framework for accounting personnel in China is not satisfying. The knowledge structure of accounting education in China is still narrow. The cross-disciplinary knowledge is not well valued. And the skill training is relatively weak. Therefore, we must pay attention to the on-the-job training of accounting personnel, so that they can possess professional ability, solid professional foundation, comprehensive coordination ability, as well as the ability to accurately master and implement policies and regulations, the ability to manage risks, the organization and management ability, the innovation ability, the communication ability, and the ability to be familiar with related disciplinary knowledge.

The low moral quality of accounting personnel has much to do with insufficient education. In the regular college education of accounting, the lessons of professional ethics should be opened. Meanwhile, effective professional ethics education should also been conducted on the accounting personnel, so that they can establish correct outlook of professional ethics, abide by the norms of accounting professional ethics, conscientiously enhance the professional and moral cultivation,

enhance the awareness of loving the job, stress the dedication to career, maintain the dignity of accounting profession, and establish favorable social image.

C. *Strengthen Construction of Accounting Standards, and Guard Earnings Management of Listed Companies*

1) *Formulate the disclosure system for the information of listed companies:* Increase the disclosure of related party relations and their transactions; disclose the formation and accounting method of the report items that can be easily used to manipulate the earnings; require the listed company to disclose the cause and effect, as well as the process of major events. For the listed company without information disclosure, it must be blamed that it lacks of details in the supplementary declared annual report. But for the economic activities that have large influence on the operation of the company, the earnings management should be restricted.

2) *Establish and perfect high quality system of accounting standards:* Because the earnings management of most listed companies is conducted on the premise of not violating the accounting standards. Therefore, it is also an effective method to narrow the space for earnings management through establishing and improving the accounting standards and accounting system. To strengthen the construction of accounting standards and accounting system, the prospective high quality accounting standards should be formulated, so as to reduce time lag and the indeterminacy of accounting as much as possible.

D. *Strengthen Policy Supervision, and Establish Performance Evaluation Index System*

The supervisory authority should reform the existing supervision policy that depends on single accounting data, so as to prevent the enterprise from utilizing “fair value” to readjust profit under the new accounting standards, prevent people from manipulating the stock price of capital market and stock market, and also avoid the management level of listed companies from utilizing various means to meet the requirements of control, for the purpose of realizing allotment and turning from the losses to profits. Therefore, it is necessary to establish a set of practical and effective performance evaluation index system that combines the long-term and short-term performance of the listed company. For instance, on the basis of regarding the cash flow of business activities and economic value added as the core index, it can increase the effective early warning index of enterprise earnings management, such as asset evaluation reduction.

E. *Strengthen Independency for Audit, and Enhance the Auditing Quality of Chartered Accountant*

The release of new standards may restrain the earnings management of listed companies to certain degree, but the concrete situation of listed companies that the chartered accountant faces is complicated. The hidden and ingenuity of earnings management for listed companies are usually one of the risk factors for independent auditing. Therefore, it is

extremely urgent to enhance chartered accountant's ability to distinguish the earnings management of listed companies.

REFERENCES

- [1] Zhou Xige: Study on Related Issues of Enterprise Earnings Management, Friends of Accounting, 5th issue of 2008
- [2] Zhang Xiangjian: Study on Stock Allotment and Earnings Management under the Control of Large Stockholders, Press of Shanghai University of Finance and Economics, 2007
- [3] Wu Liansheng: Earnings Management System to Avoid Losses: Comparison Between Listed Companies and Unlisted Companies, Accounting Research, 2nd issue of 2007
- [4] Shen Lie, Zhang Xiping: New Accounting Standards and Earnings Management, Accounting Research, 2nd issue of 2007
- [5] Liu Zhe: Analysis and Recognition of Motives for Earnings management of Family Enterprises, Accounting Research, 14th issue of 2010