

Research on Accrual Earnings Management of F Company

Guiqian Li¹, Jing Huang¹ *

¹ *School of International Business, Jilin International Studies University, 3658 Jingyue Street, Changchun, China*

*Corresponding author. Email: huangjing@jisu.edu.cn

ABSTRACT

Reliability, as one of the basic requirements for the quality of accounting information, restricts the behaviours of accountants. However, some listed companies choose to use Accrual Earnings Management as a means to gain advantages in the capital market competition or to avoid being delisted because of losing lasting five years. It is done through the changes of accounting policies, for example, the conversion of Fixed Assets to Investment Properties measured under the fair value model. Although Accrual Earnings Management does not violate accounting standards, it can harm the sustainable development of an enterprise and even lead to distortion of financial data. Also, it will do damage to the interests of shareholders, creditors and stakeholders. This paper uses financial statement analysis, the Accrual Earnings Management Model and SEC questioning to conclude that F Company has engaged in significant Accrual Earnings Management behaviours.

Keywords: *Accrual Earnings Management, Fixed Assets, Investment Property, Loss-making Enterprise.*

1. INTRODUCTION

Scott, an American accounting scholar, argued that Accrual Earnings Management is a concrete manifestation of the economic consequences of accounting policy choices. Moreover, he argued that enterprises are bound to choose the accounting policies to maximize the utilities or market values of the enterprises as long as managers have the freedom to select different accounting policies which are known as Accrual Earnings Management.

Another accounting scholar from the US, Schiper, argued in 1989 that Accrual Earnings Management is the purposeful intervention in external financial reporting to gain some private interests instead of dealing neutrally with operating activities simply.

Further, Healy and Wahlen in 1999 explained that Earnings Management is managers use accounting judgement in preparing financial reports and structuring economic transactions to alter financial reporting, thereby misleading some stakeholders about the understanding of underlying economic benefits to the enterprise. And this concept that Healy and Wahlen explained finds general acceptance.

Theoretically, there are two types of Earnings Management: Accrual Earnings Management and Real

Earnings management. Real Earnings Management is achieved by manipulation of production costs, related party transactions and other means. Accrual Earnings Management is achieved by changes in accounting policies.

The focus of this paper is on Accrual Earnings Management. Accrual Earnings Management affects the decisions of statement users and it is therefore important to analyse the extent of Accrual Earnings Management and to identify the common Accrual Earnings Management means of loss-making companies. The purpose of this paper is to identify the Accrual Earnings Management behaviours of F Company and to make recommendations for the governance of this category of loss-making companies.

2. COMMON MEANS OF ACCRUAL EARNINGS MANAGEMENT

Common means of Accrual Earnings Management include reserving for Bad Debts on Accounts Receivable and misusing Inventory Falling Price Reserves and Fair Value Econometric Mode.

2.1. Inventory Falling Price Reserves and Bad Debts on Accounts Receivable

According to Mainland China's Enterprise Accounting Standard for Business Enterprises No. 1 - Inventories, when measuring inventories at the end of the accounting period, enterprises should use the lower cost or net realisable value of inventories, which means that if the net realisable value is lower than the cost of inventories, a corresponding provision for the decline in value of inventories needs to be recorded. However, it is worth noting that net realisable value, as one of the Accounting Measurement Attributes, relies on the judgement of corporate accountants for its value. It can easily lead to the abuse of the provision for Inventory Falling Price Reserves to smooth current profits from the accountants.

According to Mainland China's Enterprise Accounting Standard No. 22 - Financial Instruments, the enterprise should reserve Bad Debts based on the age or percentage of Accounts Receivable. However, the percentage of provision is mainly set by the enterprise. It can easily lead the accountants to judge the percentage of provision for Accounts Receivable subjectively for the sake of smoothing or inflating profits.

2.2. Misuse of Fair Value Measurement

According to Mainland China's Enterprise Accounting Standard No. 39 - Fair Value Measurement, Fair Value Measurement means that assets and liabilities are measured at the price that would be received for the sale of an asset or paid for the transfer of a liability in an orderly transaction between market participants occurring at the measurement date. At the same time, fair value measurement is a necessary way to maintain orderly property rights in the market and an important way to enhance the quality of accounting information. It represents a general trend of change in the accounting measurement system.

However, the misuse of Fair Value Measurement Attributes, for example, debt restructuring, non-monetary asset exchanges and the conversion of Fixed Assets to Investment Properties measured in the fair value model. These are all common means of Accrual Earnings Management. In addition, some Chinese and foreign scholars agree that Fair Value Measurement Attributes is still highly controversial today because of its human factor judgement, which can probably bring about operational possibilities for Earnings Management and even financial fraud.

3. CASE STUDY OF ACCRUAL EARNINGS MANAGEMENT IN F COMPANY

3.1. Misuse of Fair Value Measurement

F Company is a private equipment manufacturing enterprise in Mainland China, established in 2001, whose main business is the production and sale of photovoltaic and related ancillary equipment. It was listed on the Shenzhen Stock Exchange's A-share GEM in 2009 but already was in red in 2012 firstly. Also, it has been in the red for seven years from 2009 to 2020. The following data for analysing is sourced from the Wind database and CSMAR database and has been desensitised.

Table 1. The impact of bad debt on net profit

Year	①Bad debt	②Gross revenue	①/②	Net profit
2020	¥	135,030.8	¥	-81,554.2
2019	¥	20,624.2	¥	-791,696.2
2018	14,788.0	114,919.0	12.89%	-174,668.2
2017	-827.6	400,464.7	¥	82,976.4
2016	16,068.1	158,338.8	10.15%	-76,460.8
2015	78,797.9	156,171.7	50.46%	-479,713.9
2014	13,470.0	166,310.6	8.10%	6,672.8
2013	87,928.8	264,690.0	33.22%	-177,465.7
2012	226,006.2	211,238.4	106.99%	-691,234.3
2011	48,251.2	101,013.6	47.77%	-103,660.9
2010	6,439.6	542,757.8	1.19%	106,827.7
2009	2,011.7	355,612.7	0.57%	81,554.2

3.2. Accrual Earnings Management Behaviours of F Company

According to Mainland China's Enterprise Accounting Standard No. 3 - Investment Properties, F Company convert some Fixed Assets and Intangible Assets with a carrying value of RMB 29,808,600.00 to Investment Properties in 2021 and measured the Investment Properties using the Fair Value Measurement. However, this conversion amounted to 39.80% of the total Fixed Assets. The purpose of the large number conversion in a manufacturing company is suspicious. Therefore, it is likely that a large number of conversions by F Company were made through the change of accounting policy to use Accrual Earnings Management as a means to avoid delisting from the stock market with five consecutive years of losses. Also, for the sake of providing opportunities and time for corporate financing to relieve from capital chain breakdowns and transformative of its main business.

3.3. Effect of Accrual Earnings Management by F Company on Accounting Subjects

3.3.1. Decrease in Administrative Expenses

Administrative expenses as period costs will affect the current income statement amount. After the conversion, it will not require depreciation and amortisation anymore. In other words, there will be an inflated profit due to the reduction in depreciation and amortisation.

3.3.2. Increase in Other Comprehensive Income

If an enterprise uses the Fair Value Measurement to measure an investment property and the fair value is greater than the carrying amount at the date of conversion, the favourable difference will be credited to the credit side of Other Comprehensive Income. Although Other Comprehensive Income is an accounting subject in Owner's Equity and does not affect the current profit of Income Statement, the amount of Other Comprehensive Income involved in the sale of the investment property will be credited to the credit side of Other Operating Costs. As a result, the credit balance of Other Operating Costs will reduce the current cost of the investment property sold, which in turn will affect the profit amount of Income Statement in the period of sale to provide the possibility of Accrual Earnings Management.

The asset valuation report disclosed by F Company in 2021 indicated that the carrying amount of the assets declared for conversion was RMB29,808,600.00 and the fair value amount was RMB35,233,100.00, with a favourable difference of RMB5,444,500.00. In other words, there will be a favourable difference of RMB5,444,500.00 to be credited to other comprehensive income.

Furthermore, F Company did not enter into a finance lease contract with the lessee, but an operating lease contract. The operating lease contract is characterised by a short lease term and can be terminated even before the contract period after a negotiation. In short, an operating lease contract is characterised by a short lease term and can be cancelled. As a consequence, F Company probably will sell the asset after the short-term termination of the operating lease. If it is, it will influence the figure of current profit in the Income Statement.

3.3.3. Increase in Gains and Losses from Changes in Fair Value

Even if F Company does not sell these Investment Properties to achieve the purposes of Accrual Earnings Management, the favourable differences increasing from the changes in fair value of Investment Properties

will be credited to Gains and Losses from Changes in Fair Value to affect the current profit directly.

Further, there are also some difficulties and financial fraud in the fair value assessment of subsequent measurement of investment properties. For example, there is a tendency to use value appraisals to assess fair value instead of prices of transactions in certain cities where there are fewer market transactions. Nevertheless, asset valuation is highly subjective and is prone to financial fraud in the form of related party valuation or even fictitious fair value of assets.

3.3.4. Increase in Other Operating Income

After the conversion to Investment properties, the leases income from current leases will be included in Other Operating Income, which in turn will affect the profit for the period through the Operating Income of Income Statement to achieve the purpose of Accrual Earnings management.

However, it is not a healthy business model for F Company, as a manufacturing company, to convert its manufacturing plant to rental use and rely on leases income generated from rentals to offset its losses. In the short term, the profit of the Income Statement would increase. But in the long term, reliance on rental income does not allow a business to continue as a going concern. Moreover, the profit manipulation by F Company has affected the Reliability of the quality of accounting information. In particular, F Company as a listed company, Accrual Earnings Management will seriously affect the interests of creditors and shareholders.

3.4. Modified Jones Model to Verify Discretionary Accruals level of F Company in the Same Industry

This paper takes A-share listed companies in the same industry as Company F from 2009 to 2020 as the research sample, and the rules for selecting the sample are as follows: (1) exclude the sample of companies in the financial sector; (2) exclude the sample with missing relevant data. Furthermore, referring to Dechow's modified Jones model, Discretionary Accruals which is used to measure the level of Accrual Earnings Management was calculated to compare F Company and other A-share listed companies in the same industry.

The absolute values of Discretionary Accruals and ranking shows that profit manipulation of F Company has been at a high level within its industry since 2011. In other words, F Company has had accrual earnings management behaviours since 2011.

Table 2. Ranking of discretionary accruals of F company in the same industry

Year	Absolute values of discretionary accruals	Number of companies in the sample	Ranking in the same industry
2020	0.1050	225	62
2019	0.2789	200	8
2018	0.3013	194	5
2017	0.0678	181	61
2016	0.2131	159	5
2015	0.5514	141	2
2014	0.4116	132	73
2013	0.0370	127	122
2012	0.1823	113	8
2011	0.1465	104	27
2010	0.0682	75	46
2009	₩	59	₩

4. MEASURES TO CONTAIN ACCRUAL EARNINGS MANAGEMENT

4.1. Expanding Business Profitability

The reason why loss-making enterprises have an incentive to manipulate the profit is that they are under pressure to exit the stock market. As a result, only by addressing the root causes of the Accrual Earnings Management motivation which is known as improving the profitability of loss-making enterprises can stop Earnings management.

For the sake of comparing F company with other companies in the same industry, Chinese listed private enterprise Z Company which is with a similar and comparable date of incorporation and registered capital with F Company in the same industry was used to compare in this paper. The comparison reveals that both of profitability and market share of F Company is at a disadvantage within its industry.

Table 3. Comparison of return of equity

Year	F company	Z company
2020	-261.84%	19.66%
2019	-198.60%	16.81%
2018	-134.48%	17.22%
2017	31.54%	13.00%
2016	-36.91%	7.45%
2015	-181.00%	6.94%
2014	5.93%	4.58%
2013	-26.58%	3.10%

2012	-64.16%	12.41%
2011	6.11%	₩
2010	8.58%	₩
2009	7.20%	₩

In these nine years from 2012 to 2020, F Company had a negative ROE seven years. Even, it had a return on net assets of -261.84% in 2020 under the dual pressure of weak business profitability and COVID-19 outbreak. It is clear that Accrual Earnings Management cannot turn losses into profits and that only by expanding the profitability of the business can the trend of losses be fundamentally reversed.

Therefore, the correct way to end the loss-making of an enterprise is creating revenue from the new business instead of whitewashing financial statement figures through the changes of accounting policies.

4.2. Strengthening Internal Control

For the sake of reducing Earnings Management to improve the quality of accounting information and business operations, internal control and risk assessment must be paid a high attention by enterprises. This risk assessment is not only about the financial data, but also in from sales operations to all aspects of business operations.

Accounts Receivable of F Company amounted to RMB 118,670,200.00 in 2020, representing a 795.87% increase year-on-year from the last year. Despite the huge increase in Gross Revenue of F company in 2020, it has already experienced serious Accounts Receivable Management problems in the last decade and collectability of the huge amount of Accounts Receivable is still suspicious.

Ignoring the age and quality of Accounts Receivable is one of the manifestations of the lack of internal controls. Moreover, Accounts Receivable of F Company ageing of 3 years or more in 2019 and 2020 are 90.41% and 67.39% respectively. An imbalance in internal controls over Accounts Receivable can probably lead to encroachment on cash flow and increase the need to raise external debt. As mentioned earlier Capitalization ratio of F company in 2020 is as high as 14.3. A large amount of debt will increase finance costs to lower the profit margins down and affect the amount of net profit to further deepen the motivation for Earnings Management.

Furthermore, the recognition of sales revenue requires the payment of corresponding corporate income tax, but the improper management of Accounts Receivable will result in the main business income becoming a financial figure instead of the corresponding

monetary funds. The stressed cash flow and income tax will increase the financial pressure on the enterprise.

Therefore, internal control is particularly important for loss-making enterprises. The sales operation which emphasized quality and risk control can mitigate the possibility of continued losses and reduce the motivation of earnings management.

5. CONCLUSIONS

This paper uses financial statement analysis, the Accrual Earnings Management Model and SEC questioning to conclude that F Company has engaged in significant Accrual Earnings Management behaviours.

Accrual Earnings management of F Company through the changes of accounting policies although in the short term can be inflated profits and whitewash the net profit value of the income statement. But in the long term interests, it is not conducive to the healthy development of an enterprise. Improper internal controls can also affect the level of corporate governance and financial management capabilities, and may even turn into financial fraud.

The significance of this paper is to make a judgement on the extent of Accrual Earnings Management in F Company by combining the Accrual Earnings Management model and comparing it with the same industry Z company. At the same time, the contribution of this paper to the field of Accrual Earnings management research lies in the use of the Accrual Earnings Management model to measure the degree of Accrual Earnings Management in the case study, providing a study of the degree of Accrual Earnings Management besides the accounting account perspective. However, the weakness of this paper is that F Company is a Lossing-making company and the findings of the study are not representative of a wide range of non-loss making companies. In subsequent studies, it is hoped that the sample and scope of the study can be expanded to produce findings that can be used more widely.

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