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Exploration of Research on Earnings Management

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Abstract

Earnings management refers to the practice where companies manipulate financial statements to alter their true economic condition to achieve certain objectives. Earnings management impacts the quality of a company's financial reporting and market efficiency. It is closely related to factors such as fiduciary responsibility, corporate tax burden, relational transactions, internal controls, litigation risk, and CEO characteristics. The main methods include earnings manipulation, real activity earnings management, and accrual-based earnings management. Engaging in earnings management negatively affects the authenticity and reliability of a company's financial statements and information disclosure. Therefore, companies should improve internal control and supervision mechanisms to reduce the likelihood of adverse impacts.

Keywords: Earnings Management; Financial report; Information asymmetry; Governance mechanism; Regulatory agency

1 Introduction

1.1 The Concept and Characteristics of Earnings Management

Earnings management refers to the actions taken by companies during the preparation of financial statements to achieve specific objectives by manipulating accounting policies or actual economic activities. The main characteristics of earnings management include diversity, complexity, and concealment. The methods of earnings management are diverse and can be achieved through adjustments in accounting estimates and policies or by manipulating actual economic activities. Additionally, earnings management behaviors are often complex, involving multiple aspects of financial data and information, requiring a deep understanding and mastery of financial statement preparation by the practitioners. Earnings management also has a certain degree of concealment, making it difficult for

external auditors and regulatory bodies to detect and identify, which increases the difficulty of its supervision and prevention.

1.2 The Background and Significance of Earnings Management Research

Earnings management is a highly valuable topic in the field of financial accounting, having significant implications for corporate governance, investor decision-making, and market efficiency. The background and significance of earnings management research are mainly reflected in the following aspects: Firstly, earnings management is a hot issue in corporate governance and financial reporting. Research on this topic helps reveal the behaviors of corporate management and the authenticity of financial reports, which is significant for improving corporate governance and protecting investors' interests [1]. Secondly, earnings management research contributes to a deeper understanding of the quality and transparency of corporate financial reporting, providing investors with more accurate financial information and promoting the scientific and accurate decision-making of investors [2]. Additionally, earnings management research can provide references for regulatory authorities, aiding in the improvement of relevant laws, regulations, and supervision policies, thereby enhancing market transparency and efficiency [3].

2 Theoretical Foundations of Earnings Management

2.1 Agency Theory

Agency theory is one of the important theoretical foundations for earnings management research. It primarily studies the agency relationship between principals and agents and how agents exercise power and fulfill responsibilities within this relationship. Agency theory posits that due to information asymmetry and conflicts of interest, agents may exploit their power for earnings management to pursue personal interests. For example, management might manipulate financial statements to meet their own interests [1].

Agency theory significantly influences earnings management by highlighting the existence of agency costs and problems, making earnings management a possible behavior. It suggests supervision and incentive measures to mitigate agency problems, thereby reducing the likelihood of earnings management. For instance, establishing effective incentive mechanisms and supervision systems can reduce agents' earnings management behaviors. Agency theory also emphasizes the conflicts of interest between shareholders and management, which can lead to earnings management. Therefore, understanding the influence of agency theory on earnings management is crucial for comprehending the motivations and mechanisms of earnings management behaviors [2].

Through in-depth research on agency theory, we can better understand the motivations and mechanisms behind earnings management behaviors, providing theoretical support for effectively preventing and regulating these behaviors.

2.2 Signaling Theory

Signaling theory is also a significant theoretical foundation for earnings management research. This theory posits that companies convey information to the outside world in various ways, and this information influences the perception and judgment of investors, analysts, and other stakeholders regarding the company's earnings management behaviors. Signaling theory emphasizes the asymmetry and incompleteness of information, as well as the interpretation and reaction of market participants to the company's actions [4]. In earnings management research, signaling theory is important for explaining why companies engage in earnings management, the motivations behind such behaviors, and the impact of these behaviors on the decision-making of market participants.

Signaling theory suggests that a company's earnings management behavior can be seen as a signal that conveys information about the company's future performance, risk, and potential value to the outside world. Companies may attempt to send positive performance signals to the market through earnings management to boost stock prices or reduce financing costs.

Moreover, signaling theory underscores the interpretation and reaction of market participants to earnings management behaviors. Investors make investment decisions based on the company's earnings management behaviors, which in turn affect the company's stock price and financing costs. Therefore, companies need to consider market participants' reactions and the potential consequences when engaging in earnings management.

2.3 Income Smoothing Theory

Income smoothing refers to the intentional manipulation of financial statements by company management through accounting policies and estimates to achieve specific economic goals. Income smoothing theory includes managerial motive theory, information asymmetry theory, and agency theory. Managerial motive theory suggests that management engages in earnings management for personal benefits, such as to obtain rewards or avoid penalties. Information asymmetry theory points out that market participants lack sufficient knowledge about internal company information, allowing management to influence market expectations through earnings management. Agency theory asserts that there are agency relationships within the company, and management uses earnings management to balance the interests of various parties.

In summary, agency theory, signaling theory, and income smoothing theory are the theoretical foundations for studying earnings management. This paper will continue to analyze the practical behaviors of earnings management based on these three theories.

3. Analysis of Earnings Management Practices

3.1 Motivations for Earnings Management

Earnings management involves the intentional adjustment of earnings levels in financial statements by companies. The primary motivations for engaging in earnings management include tax planning, managerial incentives, market expectation management, and contractual rewards.

3.1.1 Tax Planning

Tax planning is a crucial component of corporate financial management and serves as a significant motivation for earnings management. In modern business operations, tax costs account for a considerable portion of a company's operating costs, making reasonable and legal tax planning essential for reducing overall tax burden and enhancing capital efficiency.

Research indicates that within the framework of tax regulations and policies, companies adopt various measures to adjust their financial reports to achieve tax optimization. These measures include choosing different accounting policies, timing transactions, utilizing tax credits, and taking advantage of tax incentives. Especially when faced with high tax rates, management is more motivated to use earnings management to adjust taxable income, thereby reducing the tax burden. Methods for reducing tax burdens through earnings management are diverse, such as accelerating depreciation or amortization to lower taxable income for the current period or deferring income recognition to delay tax payments .

3.1.2 Managerial Incentives and Market Expectation Management

Managerial incentives also play a significant role in driving earnings management. The compensation structure of corporate management is often closely tied to the company's financial performance, particularly earnings levels. This structure incentivizes management to adjust reported earnings figures through various means to meet or exceed market expectations, thereby maximizing personal compensation and rewards.

Additionally, market expectation management is another motivation for earnings management. Companies may engage in earnings management to adjust market expectations of their future performance, influencing stock price performance and investor confidence.

3.1.3 Contractual Rewards

Contractual rewards are another reason for earnings management. In many cases, company agreements, including debt contracts, managerial incentive contracts, and supply chain agreements, contain specific terms related to earnings. These terms stipulate minimum or specific earnings levels that must be achieved to trigger rewards or avoid

penalties. Companies engage in earnings management to meet specific contractual earnings requirements to obtain rewards or avoid penalties .

In summary, tax planning, managerial incentives, market expectation management, and contractual rewards are the primary motivations for earnings management. These motivations influence the emergence and development of earnings management behaviors and impact the authenticity and transparency of corporate financial statements.

3.2 Methods of Earnings Management

In practice, companies employ various methods to manage earnings. Common methods include earnings manipulation, real activities earnings management, and accrual-based earnings management.

3.2.1 Earnings Manipulation

Earnings manipulation involves adjusting accounting policies and estimates to manipulate earnings to achieve specific financial statement targets set by management. This can be achieved through changing accounting estimates, revenue and expense recognition, asset impairment, etc. Earnings manipulation is typically aimed at influencing investors' and stakeholders' perceptions of the company's financial condition and operating performance to achieve specific management objectives.

3.2.2 Real Activities Earnings Management

Real activities earnings management involves adjusting actual business activities to influence earnings levels. This includes adjusting sales policies, production costs, research and development expenditures, and other operational activities. Compared to earnings manipulation, real activities earnings management directly affects the company's operations and performance, making it more challenging to implement and requiring a higher level of expertise.

3.2.3 Accrual-Based Earnings Management

Accrual-based earnings management involves adjusting accounting estimates and policies to influence accrual items in financial statements, thereby manipulating earnings levels . This method includes adjusting the timing, amount, and assumptions of accrual items to achieve earnings management objectives.

In summary, these methods impact the financial statements and operating performance of companies to varying degrees, also affecting investors' and stakeholders' decision-making. Therefore, understanding and monitoring earnings management behaviors are crucial for companies and regulatory authorities.

3.3 Factors Influencing Earnings Management

The factors influencing earnings management behaviors are multifaceted, including fiduciary relationships, corporate tax burden, relational transactions, internal control, litigation risk, and CEO characteristics.

3.3.1 Fiduciary Relationships

The fiduciary relationship, namely the management's responsibility and obligation to shareholders, significantly impacts earnings management behaviors. This influence is reflected in the management's pursuit of personal interests, where they may adopt accounting methods to adjust financial reports to meet market expectations or personal incentive goals.

Research shows that when management holds stock options, the relationship between management and earnings management becomes closer. Stock options, as an incentive mechanism, tie management's interests to the company's stock price. Thus, management is motivated to engage in earnings management to enhance short-term earnings, thereby boosting the stock price and increasing the value of their stock options .

3.3.2 Corporate Tax Burden

There is a significant negative correlation between earnings management and the overall tax burden of a company. During earnings management, management takes measures to reduce the company's taxable income to decrease the tax burden. This includes deferring revenue recognition, accelerating expense recognition, or utilizing tax incentives.

Deferred revenue recognition allows management to shift revenue to future periods, thereby reducing current taxable income. Accelerated expense recognition involves recognizing more expenses in the current period, such as early depreciation, amortization, or provisioning expenses, to increase current tax losses or reduce pre-tax profits. Management may also utilize government-provided tax reductions, credits, or deferrals to legally reduce the tax burden by adjusting bad debt reserves, inventory write-downs, or other accounting estimates, influencing pre-tax profits within accounting standards.

3.3.3 Internal Control and Relational Transactions

The internal control mechanism is a key component of corporate governance structures, significantly constraining earnings management behaviors. High-quality internal control not only enhances the accuracy and reliability of financial reporting but also effectively inhibits inappropriate earnings management behaviors, particularly those induced by supplier relational transactions.

High-quality internal control ensures that revenue and expense recognition adhere to established accounting standards and company policies, reducing management's room for manipulating earnings. Effective internal control supervises and evaluates business decisions to ensure they are based on long-term strategies and market conditions rather

than short-term earnings goals. By regulating financial reporting processes and strengthening audit supervision, internal control mechanisms increase transparency and compliance, preventing earnings management behaviors and ensuring that financial reports accurately reflect the company's operating conditions.

Internal control mechanisms help identify and manage risks associated with earnings management, including legal, market, and reputational risks. By promptly identifying and addressing these risks, companies can avoid potential losses from earnings management. High-quality internal control mechanisms promote an integrity and transparency culture, encouraging employees to adhere to professional ethics and company policies, fundamentally inhibiting inappropriate earnings management behaviors.

Supplier relational transactions may involve improper benefits exchanges, such as recognizing procurement costs early to boost current earnings. Internal control mechanisms ensure all procurement activities are based on fair market conditions and transparent decision-making processes .

By inhibiting inappropriate earnings management behaviors, internal control mechanisms protect investors' interests, ensuring they receive accurate and reliable financial information for informed investment decisions.

3.3.4 CEO Characteristics

As the company's top manager, the CEO's personal characteristics, values, tenure, and career goals significantly impact the company's earnings management behaviors. Research indicates a significant correlation between CEO tenure and earnings management, especially when the CEO's tenure is nearing its end .

When the CEO's tenure is ending, they focus more on final performance as it directly impacts their reputation, bonuses, and retirement benefits. Hence, the CEO may adopt earnings management to embellish financial statements to ensure end-of-tenure earnings performance meets or exceeds expectations, showing a positive relationship between the two. Conversely, another scenario shows a significant negative correlation between nearing-end tenure CEOs and earnings management, as these CEOs tend to adopt conservative strategies to avoid negative events affecting their reputation. They engage in earnings management to reserve earnings for contingencies or reduce unnecessary expenses to increase earnings. As tenure ends, the CEO emphasizes risk management, avoiding financial problems in the final phase, thereby smoothing earnings through earnings management for financial stability.

3.3.5 Audit Committee and Board Characteristics

The independence of the audit committee, meaning no direct association or conflict of interest with company management, enhances its oversight effectiveness, inhibiting management's motivations and abilities for earnings management. Highly independent

audit committees can identify and correct abnormal accrual items, reducing earnings management behaviors.

Similarly, board independence significantly impacts earnings management behaviors. Independent directors, not directly involved in daily operations, can objectively evaluate management behaviors and supervise and constrain earnings management. Highly independent boards and audit committees can establish effective oversight and accountability mechanisms, ensuring management's decision-making process is transparent and reasonable, reducing earnings management opportunities. They emphasize long-term value creation through effective earnings management oversight, promoting sustainable development and preventing management from engaging in earnings management for short-term goals.

Given the above results, fiduciary relationships, internal control mechanisms, litigation risk, CEO characteristics, and audit committee and board characteristics significantly influence earnings management behaviors. These factors collectively affect the practice of earnings management.

3.4 Impact of Earnings Management on Corporate Performance and Information Disclosure Quality

Earnings management behaviors impact both corporate financial status and operating performance and the authenticity and transparency of information disclosure. When studying the impact of earnings management on corporate performance and information disclosure quality, multiple factors must be considered comprehensively.

3.4.1 Impact on Financial Statements

Firstly, earnings management behaviors affect the company's financial status and operating performance. Earnings management may distort financial statements, influencing investors' accurate assessment of the company's value. For example, some companies use earnings management to cover actual operating conditions, misleading investors about the company's value. Additionally, earnings management behaviors may negatively impact the company's operating performance, such as inflating profits to conceal actual operational issues, affecting long-term development.

3.4.2 Impact on the Authenticity and Transparency of Information Disclosure

Earnings management behaviors also affect the authenticity and transparency of information disclosure. Earnings management leads to uncertainty and misleading information in disclosures, impacting investors' understanding of the company's risks and value. Furthermore, improper earnings management reduces the company's credibility and damages its reputation, negatively affecting its ability to raise funds in capital markets and long-term development.

In conclusion, earnings management significantly impacts corporate financial status, operating performance, and information disclosure quality. Enhancing the authenticity and transparency of information disclosure and improving corporate governance are essential for preventing and mitigating earnings management risks.

4. Regulation and Supervision of Earnings Management

4.1 Improvement of Accounting Standards

Improving accounting standards plays a crucial role in regulating earnings management behaviors. Enhanced accounting standards can standardize the preparation and disclosure of financial statements, thereby limiting opportunities for earnings management. Comprehensive accounting standards provide clear guidelines and procedures for accounting practices, reducing the scope for earnings management. They also mandate comprehensive and truthful disclosure of financial statements, increasing transparency and reducing the likelihood of earnings management. Furthermore, improved accounting standards strengthen the supervision and penalties for earnings management behaviors, increasing the cost and risk associated with such practices and thus reducing the motivation for earnings management. Therefore, the improvement of accounting standards positively contributes to regulating earnings management, maintaining the authenticity and reliability of financial statements, protecting investors' interests, and promoting healthy market development.

4.2 Strengthening Internal Controls

Strengthening internal controls within a company is vital in preventing earnings management. Internal control refers to the policies, procedures, and regulations established by a company to achieve operational goals, ensure the safe use of resources, secure asset safety, ensure the reliability and timeliness of financial reporting, comply with laws and company policies, and improve economic efficiency and management effectiveness. Effective internal controls can supervise and constrain the behaviors of management, preventing earnings management.

4.2.1 Enhancing the Reliability and Transparency of Financial Reporting

Strengthening internal controls enhances the reliability and transparency of financial reporting. A robust internal control system can effectively monitor the financial reporting process, reducing the potential for human intervention and manipulation, thus improving the authenticity and comparability of financial reports. This helps to mitigate the impact of earnings management on financial reporting, safeguarding the interests of investors and stakeholders.

4.2.2 Regulating Management Behavior

Strengthening internal controls can regulate management behavior and reduce the space for earnings management. The establishment and implementation of internal control systems can clearly define the responsibilities and authorities of management, standardize their behaviors, and prevent them from using their positions to engage in earnings management. Additionally, internal controls enhance the supervision and management of various business activities, reducing opportunities and motivations for earnings management.

4.2.3 Improving Overall Risk Management

Strengthening internal controls improves a company's overall risk management. Earnings management often carries certain risks, and enhancing internal controls can help companies timely identify and address potential risks, reducing the adverse impact of earnings management on operations. A sound internal control system also improves corporate governance, enhancing the company's sustainable development capabilities.

In summary, strengthening internal controls plays a critical role in preventing earnings management. By establishing and maintaining robust internal control systems, companies can improve the reliability and transparency of financial reporting, regulate management behavior, and enhance overall risk management, effectively preventing earnings management behaviors.

4.3 Establishing and Improving External Regulatory Mechanisms

Establishing sound external regulatory mechanisms is essential in curbing earnings management behaviors. A robust external regulatory mechanism can enhance the transparency and traceability of earnings management behaviors, thereby reducing the likelihood of companies engaging in earnings management. The establishment of external regulatory mechanisms can reinforce corporate governance structures, prompting management to treat earnings management more cautiously. It also strengthens the audit and supervision of financial statements, reducing the impact of earnings management on financial reporting.

Therefore, establishing and improving external regulatory mechanisms plays a crucial role in curbing earnings management behaviors, maintaining market order, and protecting investors' interests.

5. Conclusion and Recommendations

5.1 Research Conclusions

This study, through a comprehensive analysis of relevant literature on earnings management, draws the following conclusions: Earnings management, as a financial management strategy, profoundly impacts the quality of financial reporting and market efficiency. It is closely linked to corporate stewardship, relational transactions, internal control mechanisms, potential litigation risks, and CEO characteristics. Earnings management practices typically involve various methods, including earnings manipulation, adjusting real operational activities to influence earnings results, and using accrual accounting items to adjust earnings.

When companies engage in earnings management, they adopt methods to adjust the numbers in their financial statements, which may help achieve specific financial goals in the short term but harm the transparency and reliability of financial disclosures in the long run. Excessive reliance on earnings management to shape financial performance can lead to misunderstandings about the company's financial condition, affecting the decisions of investors and other stakeholders.

5.2 Recommendations

Based on the above conclusions, the following recommendations are proposed: First, tax authorities

should pay more attention to the impact of earnings management on corporate tax burden during tax collection and decision-making processes, strengthening the supervision of accrual items and real activities management. Second, companies should emphasize the biographical characteristics of CEOs when appointing them to reduce the risk of earnings management. Additionally, companies should enhance internal controls and regulate relational transactions to minimize earnings management behaviors. For companies facing litigation risks, attention should be given to the reasonableness of their charitable donations, combining institutional and information environments for risk management. For the implementation of specific delisting systems, regulatory authorities should strengthen the supervision of non-systematic risks and stock valuations. In terms of R&D disclosure, companies should focus more on the disclosure methods in board reports to enhance market recognition.

Regulatory authorities should intensify the supervision of corporate earnings management behaviors. In earnings management detection, multiple models should be considered to improve detection effectiveness. For audit committees and boards of directors, their independence should be strengthened to enhance the supervision of earnings management behaviors. Finally, accounting standards setters should consider the impact of earnings management on resource allocation and strengthen the regulation of earnings management behaviors.

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