Existing Possibility Analysis of Chinese Listed Companies’ Earnings Management under the New Accounting Guidelines

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Abstract: After the implementation of new accounting standards, can it inhibit the behavior of earnings management of listed companies effectively? Through the investigation of 84 listed companies' ways of profiting in Shanghai stock market and the composition of the profits as well as the analysis on the profits' decomposition's influence to the total profits, and we found that after the implementation of the new guidelines, the listed company's earnings management behavior still exists, and the listed companies, mainly through non-operating incomes and income on investment, the two deficits of the non-recurrent items to profit.

Keywords: Earnings Management; New Criteria; Profit through the non-recurrent items

1. Introduction

In China, the qualification of listing is a valuable resource. Once a company acquires the listing qualification, which can make the enterprise enjoy a kind of privilege in the capital markets by issuing shares to raise funds needed for the enterprise’ development, so companies are competing for or trying to keep this resource.

According to Chinese relevant regulations, a listed company must meet the following conditions. First, Stocks have been approved by the State Council and have been issued to the public. Second, the total share capital is no less than 50 million Yuan. Third, Opened more than three years and the last three years keep consecutive profitable. Fourth, the holders of shares face value above 1,000 Yuan are no less than 1,000. Fifth, the shares issued to the public can be up to 25% or more, if the shares’ public issuing is more than 400 million Yuan, the proportion is no less than 15%. In addition, in the last three years, three are no major violations, no false in the accounting records and so on. Besides, The Stock Exchange also has the corresponding restrictions to the enterprises having been obtained the Listing Qualifications. If the listing company has been consecutive loss for two years, it will be special treatment (ST). If the listing company has been consecutive loss for three years, it will be particular transferred (PT). If the loss is continued into the fourth year, it will be delisted. Obviously, this result is unwanted to any listed company, so to prevent this happening, the managers of many listed companies, in the losses of the third year, the second year, and even the first year, will aim to find a hidden and secure legitimate behavior (if taking illegal behavior, will be delisted also) to manipulate the profit. Thus, a kind of behavior occurred that it is permitted by accounting standards (legal), but can manipulate profit through "processing" accounting information to Manipulate profits (irrational), which is defined as Earnings Management by accounting scholars. It seems that accounting standards has become listed companies’ earnings management "umbrella."

January 1, 2007, the new accounting standards began to implement formally in China. The new accounting standards had been in the full discussion of accounting academics for more than ten years, and it can be conscious against of the earnings management space in many ways. But whether the new accounting guidelines can effectively curb the earnings management of listed companies, has become a new hot spot to scholars.

2. Literatures Review

Looking abroad for the study of the earnings management existence, the most common method is Accruals Separation Method. This approach firstly separates total accruals (TA), which are generated due to the differences between the Accrual-based net income and cash-based cash flows system in operating activities, from the enterprise's net profit. Then, estimate the overall company's earnings management by the analysis of the total accruals. The most common models are Healy Model (1985) [1], DeAngelo Model (1986) [2], Jones Model (1991) [3], Modified Jones Model (1996) and Industrial model. In addition, the other methods are Specific Item Method and Distributed Detection Method.

In China, of all the scholars’ studies in earnings management, Lu Jianqiao is the first and the most repre-
sentative one (1999). He selected 22 losses companies listed on the Shanghai Stock Exchange by the end of 1997 as a sample, and found that Chinese listed companies preferred to make use of unexpected accruals to increase profits in order to avoid continuous losses. Sun Zheng and Wang Yuetang (1999) found that the high points of listed companies’ Earnings management are when allot shares, is of meager profit and Serious loss through the way of the listed companies’ overall test mainly considering net assets income rate. Wu Donghui (2001) found Chinese listed Companies’ capacity of reporting unexpected accruals would reduce with the increase of the age a company listed, accrued assets and accrued liabilities by the use of Jones Model. Cheng Shuqiang (2006) chose A shares in Shanghai Stock Exchange from 2000 to 2003 as the sample and found that the timeliness of earnings information was associated with the proportion of institutional ownership. Pu Hua and Zhang Yuyang (2008) chose meager profit listed companies in Chinese manufacture industry from year 2002 to 2005 as the sample and confirmed that meager profit listed companies were of obvious phenomenon of earnings management through the analyze of EPS distribution density function. Qian Haiting (2008) studied a share of Shanghai and Shenzhen Stock Exchange and built earnings management measurement model through the use of frequency location mode, so she found listed companies often use accounting standards manipulation of accounting earnings information and large shareholders are positively related with earnings management.

After the implementation of the new accounting guidelines, there are many domestic scholars have been studied earnings management under the new guidelines, but it is of relatively small sample size on empirical research, which make the representation of the whole space still controversial. On theoretical research, most are focused on the comparison of old and new accounting standards, so only few are focused on the study of earnings management space and the ways and approaches under new accounting standards.

For this, the paper selected 84 listed companies in Shanghai Stock Exchange, which go out of loss in the first year of the implementation of the new guidelines, as the sample to seek the possibility and approaches through the composition of the profits as well as the analysis on the profits' decomposition's influence to the total profits.

3. The behavior of enterprises’ turning losses listed in shanghai stock market in year 2007

3.1 Sample Selection

From 2007 annual report of the overall data of Shanghai Stock Exchange listed companies, there are 66 companies (7.5%) loss, which is significant reduction in loss compared to the previous year’s 100 loss-making enterprises (11.8%). Above the 100 companies loss in 2006, there are 84 companies making up the deficits and getting surpluses in 2007(84%). It seemed that the overall operating conditions of the listed companies is improving and followed the stock market should also be prosperity and rising. However, so far from 2008 the Chinese Stock has dropped several thousand points. There is no doubt that it is associated with the context of economic globalization and the Southeast Asian financial crisis, but we have to query whether Chinese listed companies’ reported annual data is really true and fair reflection of the listed company's financial results and operating results. Further collected the information of 84 loss companies of the Shanghai stock market in 2007 and analyze on the profits’ decomposition's influence to the total profits to test whether the total profit profitable for the existence of earnings management argument.

Total profits of enterprises are composed by main operating income (a defined index that is equaled to operating revenues minus operating expenses, business tariff and annex and period expenses), loss from asset devaluation, sound value flexible loss and profit, investment income, subsidy income and non operating income. Net income is equal to the difference between total profit and income tax and whether a company will have income tax expense is determined by their total profits. So total profits and net profits, the two indicators, are basically the same. It means they will be positive or negative meanwhile, so the six indexes main operating income, loss from asset devaluation, sound value flexible loss and profit, investment income, subsidy income and non operating income will have great influences on net profit, the core index of business operation results. We use the index total profits instead of net profit for analysis assuming ignoring the deferred income tax assets and liabili-

3.2 Data analysis and conclusions

If a company’s main operating income is positive, we define the company turns losses into gains by main operating income. If a company’s main operating income is negative, we have to text continually. If main operating income plus non operating income positive, we define the company turns losses into gains by non operating incomes. If main operating income plus sound value flexible loss and profit positive, we define the company turns losses into gains by sound value flexible loss and profit. If main operating income plus investment income positive, we define the company turns losses into gains by investment income. If the above are simultaneous, we define the company turns losses into gains by integrated way. Classify the data of the 84 enterprises preliminarily to analyze the approaches they turn losses into gains and the results are as followed.
and profit have the highest proportion, which is declared income, investment income and sound value flexible loss Stock Exchange.

listed company turning losses into gains in the Shanghai proceedings management still remain in the course of the 84 operating income. In the other word, it means that earn-
able loss and profit to total profit have exceeded main operating income, investment income, loss from asset devaluation and other integrated way, which are no recurrent items. Therefore, we can judge that at least 58.33% listed companies of the 84 sample enterprises are turning losses into gains through no recurrent items under the new accounting guidelines. Is it means listed companies’ turning losses into gains through no recurrent items are the behaviors of earnings management?

Define total profits as the dependent variable $Y$, and meanwhile define separately main operating income, loss from asset devaluation, sound value flexible loss and profit, investment income, subsidy income and non operating income as independent variable $X_1$, $X_2$, $X_3$, $X_4$, $X_5$ and $X_6$ to do multiple linear regression analysis making use of SPSS17.0. Then we get the correlation matrix between the dependent variable $Y$ and the independent variables $X_i$ ($i=1$–$6$).

<table>
<thead>
<tr>
<th>$X_1$</th>
<th>$X_2$</th>
<th>$X_3$</th>
<th>$X_4$</th>
<th>$X_5$</th>
<th>$X_6$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$Y$</td>
<td>1</td>
<td>-0.513</td>
<td>0.161</td>
<td>0.582</td>
<td>0.008</td>
</tr>
<tr>
<td>$X_1$</td>
<td>0.287</td>
<td>1</td>
<td>0.306</td>
<td>0.441</td>
<td>0.535</td>
</tr>
<tr>
<td>$X_2$</td>
<td>-0.513</td>
<td>0.306</td>
<td>1</td>
<td>-0.206</td>
<td>-0.131</td>
</tr>
<tr>
<td>$X_3$</td>
<td>0.161</td>
<td>0.441</td>
<td>-0.206</td>
<td>1</td>
<td>0.654</td>
</tr>
<tr>
<td>$X_4$</td>
<td>0.582</td>
<td>0.535</td>
<td>-0.131</td>
<td>0.654</td>
<td>1</td>
</tr>
<tr>
<td>$X_5$</td>
<td>0.008</td>
<td>-0.03</td>
<td>0</td>
<td>0.654</td>
<td>1</td>
</tr>
<tr>
<td>$X_6$</td>
<td>0.703</td>
<td>-0.421</td>
<td>-0.832</td>
<td>0.204</td>
<td>0.071</td>
</tr>
</tbody>
</table>

From the above table, we can see that only 41.67% of the 84 companies turning losses into gains through main operating income, while the other 58.33% companies turning losses into gains through non operating income, investment income, loss from asset devaluation and other integrated way, which are no recurrent items. Therefore, we can judge that at least 58.33% listed companies of the 84 sample enterprises are turning losses into gains through no recurrent items under the new accounting guidelines. Is it means listed companies’ turning losses into gains through no recurrent items are the behaviors of earnings management?

Table 1. Analysis Table of Approaches’ Turning Losses into Gains

<table>
<thead>
<tr>
<th></th>
<th>Main operating income</th>
<th>Non Operating incomes</th>
<th>Investment Income</th>
<th>Loss from asset devaluation</th>
<th>Integrated Way</th>
</tr>
</thead>
<tbody>
<tr>
<td>$n$</td>
<td>35</td>
<td>33</td>
<td>11</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>$%$</td>
<td>41.67%</td>
<td>39.29%</td>
<td>13.10%</td>
<td>2.38%</td>
<td>3.57%</td>
</tr>
</tbody>
</table>

4. Analysis of the main approaches of listed companies’ earnings management

4.1 Adjusted non operating income.

Based on the results of the empirical study above, the contribution of the non operating incomes to the overall of sample enterprises have exceeded over one third in the course of turning losses into gains(39.29%). Whether the enterprises adjusted the profits increased or decreased, it will reduce the reliability of financial information, so they are all belonged to management layers’ earnings management and enterprises’ earnings management behaviors in view of turning losses into gains are mainly aimed at increasing non operating income.

4.1.1 Introduction of fair value

A remarkable characteristic of new accounting guidelines is the introduction of fair value in investment real estates, debt restructuring, amalgamation under non-unitary control and nonmonetary assets transaction. However, Chinese market economic is still of no freedom so high so that there is no sufficient condition to form fair value. In addition, according to the new accounting standards, once the assets adopt fair value measure mode, there will be no depreciation accruing any more. What we need to do is accruing reduction reserve in value when the assets have the indication of decreasing at the end of the year. In this condition the measuring of enterprises’ assets will be associated with the market completely, which is no doubt that will increase the space of enterprises’ earnings management.

4.1.2 Debt restructuring

In new accounting guidelines, it is stressed that only in the circumstances of the financial difficulties and the creditors reaching the agreement with the debtors to be willing to make concessions, we can recognize it as debt restructuring. While, if related party transactions exist, debt restructuring will still be used by enterprises’ authorities to manipulate profits. On the other hand, new accounting guidelines provides three main methods of debt restructuring, which means debtors can pay off their debts using assets such as inventory, short-term investments, fixed assets, long-term stock ownership investments and intangible assets or through the way of converting debts into capital or modifying the terms of the debts. If the company uses the first approach, it will involve the question whether the valuation of non-monetary assets is fair and the debtor should record the differences between transferring assets’ book value and fair value into current profit and loss (non-operating revenues). It is no doubt will leave some room for earnings management. If the company adopts the last two
ways with the related party existing, it will of course result in unusual income increasing.

4.1.3 With the help of enterprises’ donate gains

The new accounting guidelines changed the accounting treatment of donations, if a company receive donations, its non-operating revenues will increase so that the total profit will have inflations. So some listed companies will make use of the item to turn losses into gains with the help of the related parties’ donations on the condition of contiguous losses. About the valuation of the enterprise’ receiving donations of nonmonetary assets, the company should recognize the price according to the related vouchers that donors provided (so the price indicated in the vouchers was accounted for at historical cost) or the marketable price considering related expenses. In the other word, if the donors have non-performing assets, they will be glad to adopt the price, because it is profitable for both donors and the recipient parties. The recipient party of course will get an amount of non-performing revenues to increase total profits, while the donor can achieve the replacement of the negative assets and if the donor faces the same operating dilemma in the future, the donor can have the excuse to ask the recipient party to donate to itself. In this situation, the donor and the recipient party will become a kind of stakeholders, which will be more difficultly identified by auditors than related party.

4.2 Adjusted investment (net) income

Investment income is the second largest item of nonrecurring items except non-performing income that can affect listed companies’ total profits. A company’s investment income is mainly obtained through financial assets such as stocks, bonds and long-term stock ownership investment. There are significant changes of the new accounting guidelines in the classification of financial assets and the valuation of the long-term stock ownership investment, which give the space of enterprises’ earnings management.

4.2.1 Reclassification of the financial assets

The financial assets are classified into four types as followed. They are transaction monetary assets, hold investment due, loans and receivables and financial assets available for sale. They are different with each other in accounting treatment. However, the standard to classify the two different kinds of financial assets only lies in the initial intent how long the enterprises intend to hold when they purchase the financial assets. If the enterprise intends to sale the financial assets recently earning the differences, they will be classified into the transaction monetary assets. If the enterprise intends to hold the financial assets to the maturity, they will be classified into hold investment due. If the enterprise is not sure of the exact holding period, they will be classified into financial assets available for sale. Only making full use of the differences, listed companies can stock earnings for their selves. For example, a company purchased some stocks, they can be recorded into trading financial assets (a kind of the transaction monetary assets) and financial assets available for sale separately, so if the fair value of the financial assets increases, the increasing part recorded into financial assets available for sale can be recorded into owners’ equity (capital reserve) to stock. When the company is poor in operating income, the company can sell the stocks that recorded into financial assets available for sale so that the part of the amount previously included in equity (capital reserve) will be released and convert into investment income, which will increase the total profits too.

4.2.2 Long-term stock ownership investment

According to the new accounting guidelines, when the long-term stock ownership investment is less than the initial cost of the investment should enjoy, the difference should be recorded into the current profit and loss. It means that as long as listed companies put their money out, the investment income in the income statement will increase. Even if the company that the enterprises invested in does not have a good prospect, as long as its assets have a higher fair value, the investment will immediately become an amount of income.

4.3 Accruing reserve for assets loss reduction

The new guidelines extend the accruing of the reduction reserve to inventories, biological assets, financial assets, deferred income tax assets and so on and the accruing of the long-term assets’ reduction reserve shall not be reversed, which consciously avoid enterprises’ using of assets loss provisions to adjust earnings. But the standards of the specific assets’ accruing are still not so clear. Taking inventories for example, when the inventories’ cost is higher than its net realizable value (NRV), it should accrue inventory falling price reserves. But we usually recognize NRV in accordance with the estimated selling price less the cost of selling expenses, the related taxes and fees that expected to occur until completion. But whether the selling price the company estimates is fair and a series of costs expected to occur until completion are completely listed are needed to determine further.

4.4 Main operating income

As the empirical data is shown above, there are a total of 35 companies accounted for 41.67% turned losses into gains through main operating income. But do the sales recorded into operating income certainly having no earnings management? Current tax law provides eight kinds of such sale behaviors, but the eight kinds of deemed sale behaviors differ with each other under the new accounting standards. When the enterprises deliver the goods to others to sell, sell the consignment goods,
recognize the purchased goods, produced goods and processed goods as their investments, dividends, collective welfare or personal consumption, we should recognize income. In this way, when the company’s performance is not satisfactory they can get sales through these four ways to increase main operating income.

5. Inspirations and advices

5.1 Inspirations

We can get such a revelation, which was reached through the above empirical results and the analysis of the new accounting standards that listed companies’ earnings management will be not fundamentally eliminate only through continuous improvement of accounting standards or changes.

Although the new accounting standards compared to the old criteria, are consciously against the earnings management of listed companies in many ways to reduce the room for earnings management. But the accounting standard, as the product of human ideology, is the product of all stakeholders’ game and is inevitably of incompleteness. Any flexibility of accounting standards is possible to be used by enterprises to manage earnings.

5.2 Advices

5.2.1 Refining the accounting standards further.

At present, the framework structure of our new accounting standards has been perfecting. While it still appears slightly rough in the minutiae of specific operating requirements, so we should also keep perfecting, detailing and clearing accounting standards to reduce the uncertainty or ambiguous provisions, especially for the definitions of some "standards" and "categories". Maybe we can supplement the new accounting standards through the relevant accounting guidelines to reduce the space of earnings management and the choice degree in accounting policy [3].

5.2.2 Enhancing the recognition and disclosure of the related party

As mentioned above, the existence of related parties is still an important factor affect the quality of accounting information. No matter how rigorous the accounting standards are, as long as the related parties exist, there will be room for earnings management. Besides, the definition of related party of the present accounting standards still can not effectively identify and disclose all corporate stakeholders, which still give the business a flexibility making profit.

5.2.3 Accelerating the construction of a mature market mechanism

The introduction of fair value in the new guidelines reflects the convergence with international accounting standards. However, the Chinese market mechanism is still unable to give the full play to the advantages of fair value pricing. Therefore relevant departments should accelerate the construction of a mature market mechanism to speed up the promotion of the Chinese market to mature.

5.2.4 Completing the listing conditions of the listed companies in China

Changing the listing conditions of the listed companies in China can weaken the power of the companies to manage earnings fundamentally. The reason that the listed companies are glad to manage earnings is that they do not want to lose the listing qualifications, their hard-earned shell resources. However, in China, Stock Exchanges still regard the assessment indicators of profitability as net profit or earnings per share, which does not effectively reflect the actual state of business enterprise. So when many business enterprises are in poor conditions, they concentrate on non-recurrent items. Therefore, to change this situation, suggest changing the assessment indicators of profitability from the net profit to the core operating income and it had better to introduce the "package" targets and vertical targets conditionally. For example, when we assess the continued profitability of enterprises, should pay attention to the cumulative losses for some time or the accumulated amount of the earnings instead of focusing on a particular year.

5.2.5 Improving the building of the bond and other funding markets

Through western economists’ research of the mature western capitalist market in the financing preference we can know that companies prefers retained earnings, loans, bonds and convertible bonds to the issuance of stocks. But in China, enterprises’ preference of issuing shares is far superior to other financing methods. So at the same time of our governing of listed companies’ earnings management we must also enhance the development of other means of financing to reduce Chinese enterprises’ financing preferences to the stock.

References
