Studies in Economics and Business Administration
https://www.mfacademia.org/
ISSN:0081-7872
Vol. 3, No. 1, 2023

Analyzing Earnings Manipulation in Listed Companies: Motives, Techniques, and Controls

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Abstract:

In recent years, publicly traded companies have engaged in the manipulation of earnings for a variety of purposes, involving substantial amounts of money, which has elicited significant societal concern. This discussion begins by examining the theoretical foundations of earnings manipulation, analyzing its underlying causes, and elucidating the techniques employed in earnings manipulation through relevant case studies. Insights and warnings are then derived from financial statement analyses.

Keywords:

Listed company; Manipulating earnings; Accounting fraud.

1. Introduction

In recent years, cases of manipulating earnings by listed companies in China have been exposed by the media one after another. The huge amount of money involved caused a big sensation and aroused strong reactions in the society. Some companies even had manipulated earnings for five years, deceiving the investors. They used advanced techniques and caused investors to suffer losses. It also provokes the market economy system and the authority of regulatory agencies. Listed companies play an important role in economic development in China. The rapid development of listed companies will have a positive effect on promoting the healthy and rapid development of the securities market along the right track. However, the development of manipulating earnings will not only destroy the current order of China's securities market and make the securities market unable to fully perform its function of resource allocation, but also may make China's macroeconomic control ineffective [2].This study analyzes the motives, techniques and controls of manipulating earnings about listed companies in order to provide some identification methods to the company's stakeholders. So that users of accounting information have certain capabilities to avoid losses due to manipulating earnings.

2. Current Status of Manipulating Earnings Research

2.1. Research status abroad

The research on manipulating earnings and financial fraud started earlier abroad, and there has been a relatively mature theoretical research system. When foreign researchers analyzed the motives for manipulating earnings, they gradually formed their theory of fraud motives, and provided a more systematic and standardized theoretical basis for further identifying manipulating earnings. Based on these theories, four representative views have gradually formed. That is, Two-Factors Theory (Iceberg Theory), Three-Factors Theory (Fraud Triangle Theory), Four-Factors Theory (GONE Theory) and Risk Factors Theory [3].

The main point of the Iceberg Theory is to divide the motives for manipulating earnings into two categories: one is the objective problems in the internal management of the company, such as the soundness and strictness of its management system; the other is human behavior, including human emotions, values and attitudes. The second category of factors is more difficult to detect and prevent.The Fraud Triangle Theory. Lawrence, the father of American auditing, firstly listed abnormal needs, opportunities, and reasonableness as necessary motives for manipulating earnings.

In 1995, Dr. Albrecht re-listed the three motives as pressure, opportunity, and rationalization on Lawrence’s basis. And the three motives are indispensable. They are like the relationship between lips and teeth. Therefore, for the regulatory authorities, to prevent manipulating earnings, it is necessary not only to reduce the opportunities for company manipulation, but also to understand the pressures of companies and listen to their excuses.

The Four-Factors Theory, the GONE Theory. This theory classifies the factors that form manipulating earnings into Greed, Opportunity, Need, and Exposure. Among them, "G" and "N" are related to individuals, as well as "O" and "E" are related to the organizational environment. The innovation of this theory is that whether a company will implement manipulating earnings depends on the possibility of being exposed and the seriousness of being discovered [4].

Risk Factors Theory. So far, this is the most complete and accepted manipulating earnings motives theory. The theory divides the factors of manipulating earnings into two categories. One is individual risk factors, and the other is general risk factors [4]. Individual risk factors are unique, individual, and not controlled by the company, such as moral character. General risk factors, that is, factors that can be controlled by the company or the regulatory department, such as the opportunity for manipulating, the possibility of being exposed, the responsibility to be assumed, and the severity of punishment. When the two types of factors are considered together and it is profitable, then manipulating earnings arises.

2.2. Research status in China

Mainly because of the development of securities market grows later in China. We started late in the study of accounting manipulating earnings. In United Kingdom and the United States, they have relatively complete external markets to restrain manipulating earnings, but China lacks such external markets due to differences in social backgrounds and systems, so the study emphasizes the important impact of external factors. Mainly in the following four aspects:

First, China's legal system is not perfect and the functions of regulatory authorities cannot be fully realized [5]. The responsibility of profit manipulators is too light, and the legal awareness of some companies is also quite weak. On the other hand, the relevant rules for disclosing information are determined by the Securities Regulatory Commission, and the accounting standards implemented within the company are determined by the Ministry of Finance. The two parties cannot fully coordinate and reach agreement on the rules and standards of accounting information disclosure[5]. Moreover, the specifications and disclosure requirements of these accounting standards are time-bound. With the rapid economic development, they cannot keep pace with the times. This gives managers who manipulate accounting figures the opportunity.

Second, external audit. The reason for the audit is that the economic activities needs to be monitored. The authenticity, legality and efficiency of the company's finances, financial income and economic activities are reviewed by audit. However, the status of external auditing in our country is terrible. The weakness of audit monitoring in China due to the lack of auditor independence.

Third, information is asymmetric. Because of asymmetric information theory, it provides company managers with an opportunity to manipulating earnings, and it is also a convenient condition to cover up this manipulation behavior [7].

Fourth, cultural and moral factors. Culture is a powerful invisible resource. In the final analysis, the existence of manipulating behaviors is from the lack of morality and culture.

3. Motives of Manipulating earnings

The booming economy has promoted the securities market. With the growing economic, thousands of people begin to trade stock. It is precisely because of this opportunity that listed companies have been given the purpose of manipulating earnings in order to obtain maximum benefits. There have been relatively sufficient researches on the motives of manipulating earnings at home and abroad. The motives of listed companies are classified as follows:

3.1. Go public

In China, Securities Regulatory Commission stipulates that a company must meet the rigid condition of three consecutive years of profitability before it can go public. Therefore, in order to go public, some companies have to package their true financial status. As for the profit allotment, the China Securities Regulatory Commission also has strong regulations that the average profitability of net assets must be higher than 10% over the past three years and there is a minimum profitability limit of 6%. Only when these requirements are met can the company complete the allotment. Therefore, some companies inevitably carry out manipulating earnings for the purpose of allotment. All companies seeking the qualifications for listing must pursuit great benefits after going public. Increased salaries and increased corporate profits will also bring huge year-end dividends. This huge market temptation is also one of the main reasons for companies to manipulate earnings. In addition to listed companies, state-owned enterprises often also manipulate earnings. They increase profits in order to achieve planned goals. Or they conceal assets to reduce profits, leaving room for financial indicators for the next year.

3.2. Avoid delisting

A listed company has delisting risk, and the China Securities Regulatory Commission also has strong requirements on its operating results. If the company loses money for three consecutive years, the company must delist. The delisting of companies will also have a greater impact on stakeholders, so the senior management may use manipulation technologies to reverse this unfavorable trend.

3.3. Reduce taxes and fees

Paying taxes will cause companies to outflow cash. In order to achieve tax evasion, tax underpayment or postponement of tax payment, companies often manipulate financial statements. But there is another situation in which companies are willing to increase profits and pay more taxes. They want to create the illusion that they have good operating capabilities. This situation is mostly for stock price manipulation.

3.4. Credit funds and commercial credit

In the process of a company applying for a loan from a bank, the bank will first review the company's credit status, and then decide whether it can trust the company and grant loans to it, as well as determine the loan amount. It is of course difficult for companies with poor operating conditions to obtain bank trusts to obtain loans. Therefore, at this time, companies may manipulate a "positive" financial statement. It is not easy for companies to go public, so many companies attempt to complete backdoor listings through mergers and acquisitions. The price in the merger is of course the most important. If the company operating performance is outstanding, and the equity prices of listed companies with good capital operations are selling higher. Therefore, listed companies prepare false and eye-catching financial statements in order to have good situation in negotiations.

3.5. Performance appraisal

Regardless of external or internal assessments, a judgment on the business status of a company is mostly based on financial indicators. The return on investment, asset turnover, and sales profit rate all reflect the company's performance, which is very important for evaluation. These indicators involving accounting data have fraudulent choices and purposes.

4. Technologies of manipulating earnings

This study divides the methods of manipulating earnings into three categories: increasing current profits, increasing future profits, and concealing real profits. From these three perspectives, the profit manipulation methods are divided into: early recognition of revenue, fictitious revenue, current expenses to the future, current income to the future, future expenses to the current, one-time or unsustainable business. However, most listed companies adjust current profits for immediate profits. Therefore, the technologies to increase future profits will not be discussed.

4.1. Recognizing revenue in advance

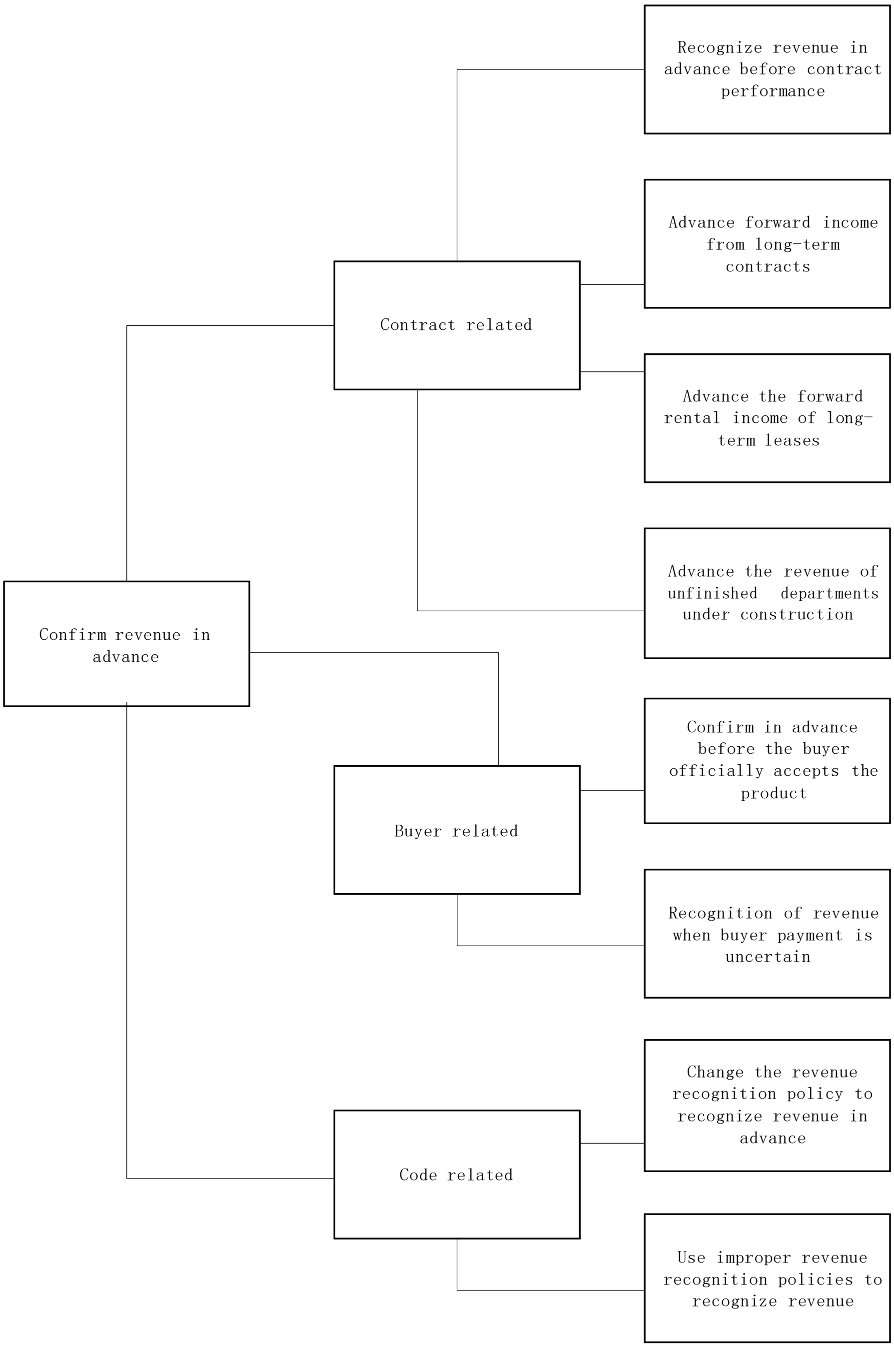

Figure 1 Recognizing revenue in advanc

The main methods of early recognition of revenue can be roughly divided into three aspects: early recognition related to contracts, early recognition related to buyers, and early recognition related to standards [5].The specific classification is shown in Figure 1:

In 2015, ChaoRi company manipulating earnings was exposed. The core technology is recognizing revenue in advance. The ChaoRi's disclosure that ChaoRi company recognized a sales income of 23.88 million in advance and the related-party company was TianHua company. The revenue and profit of this transaction were directly and falsely recorded in the financial statements for the third quarter of 2012, and the managers also approved the third quarter report of the year. On September 7, 2012, ChaoRi company signed a sales contract and the buyer was Smallpox New Energy. The contract stipulates that ChaoRi company will sell 100 million solar modules to TianHua company for a total of 500 million yuan. However, in September, ChaoRi's actual shipment was 49 million pieces, and more than half of the goods are needed to complete the contract. However, ChaoRi's company directly accounted for all of this revenue. that means, more than 200 million yuan that was suspended. And this can be regarded as a large contract for ChaoRi company. The revenue accounted for 11.4% of the operating income of the first nine months. The impact on this revenue for the financial statement is profound.

Some warnings in financial statements for early recognition of revenue: The increase in accounts receivable is significantly higher than the increase in revenue, the increase in profits exceeds actual expectations, the turnover days of accounts receivable are significantly larger, the operating cash flow is significantly less than the net profit, and the revenue is mainly from related-party sales transactions.

4.2. Fictitious income

Fictitious income is a more deceptive behavior in manipulating earnings. The technologies to recognize revenue in advance, at least this transaction is real, but only changes the time for revenue recognition. The fictitious income is mainly the empty transaction set up by the company to create profit. It does not really exist. Another situation is that even if the transaction actually exists, the amount is seriously inconsistent with the actual situation. Fictitious income is mainly divided into the four situations as shown in Figure2:

In 2014, under the storm of financial verification, TianFeng Energy company was placed under investigation for fictitious sales revenue and fictitious business performance. TianFeng Energy's sales revenue in 2010 was 109.96 million, and the inflated profit was 10.98 million, and the percentage of the inflated profit to annual revenue was about 10%; in 2011, the sales revenue was 207.88 million, and the inflated profit was 37 million. The ratio of profit to annual revenue is about 18%; sales revenue in 2012 was 270.98 million yuan, the inflated profit was 44.59 million yuan, and the ratio of inflated profit to annual revenue was about 16%. After investigation and evidence collection by the China Securities Regulatory Commission, the information released to the public indicated that most of the fictitious profits of TianFeng Energy Conservation are derived from fictitious customers, and it creates the illusion of operating income by signing sales business contracts with these fictitious customers. According to statistics, TianFeng Energy company has fabricated 74 non-existent customers and created nearly 5,800 fictitious revenues. In addition to non-existent customers, TianFeng Energy company also fabricated contracts with its own legal person customers. 14 companies participated in this transaction and created nearly 18.8 million yuan revenue. What is even more surprising is that TianFeng Energy company seriously forged bank statements in order to cover up its false records. The prospectus published by it stated that the balance of monetary funds in the balance sheet in 2011 was 65.5 million yuan. The balance was only 35.5 million, an inflated increase of 30 million.

Fictitious income often succeeds and generally requires the cooperation of the other company. Therefore, most of the fictitious income comes from related-party transactions.

4.3. The current expenses are pushed to the future

The amount of expenses also affects the company's profits. It is even a key factor to determine the profit figures on the year-end statements. Companies use Figure3 to push the current expense into the future.

Capitalize general operating expenses. These operating expenses should be included in the cost account. In order to reduce costs and increase profits, companies generally list them as assets. The construction in progress of a listed company is the most common. Expenses that cannot be capitalized are also used to incorporate costs into the construction in progress, which reduces the company's current expenses.

The amortization periods exceed a reasonable range. The extension of the amortization period will reduce the current amortization expenses. For example, for a fixed asset, the original depreciation period should be 10 years, but if the accountant extends the depreciation period to 15 years, it will inevitably reduce the annual depreciation expenses.

Assets are already showing obvious signs of falling prices, but the company does not reduce the calculations according to the facts, which will also bring inflated profits. On the surface, the company's profits are indeed good, but if there is an unexpected sharp drop in the company's assets in the future, the company's profits may cause Waterloo because of this unexpected situation. Therefore, the company should reflect the changes in the fair value of assets in the asset impairment reserve account.

There are also some warnings on the financial statements for companies to push expenses into the future: asset depreciation or amortization is too long, assets or accounts receivable have not been accurately deducted, accounting policy adjustments become aggressive, and inventories do not be deducted.

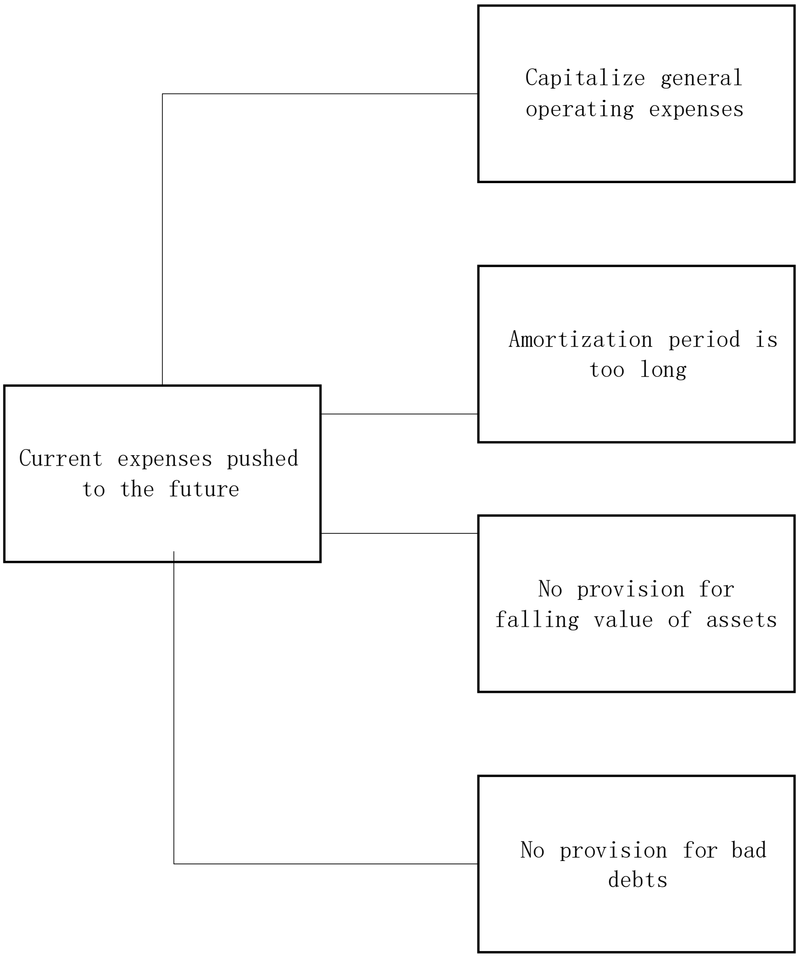

Figure 3 Current expenses pushed to the future

4.4. One-time income masks real profits

For some companies that are facing desperate situation and struggling, it is very likely that they will use unsustainable businesses to create profits and help the company out of trouble. Using one-time income to conceal real profits has a great impact on the market. Some inattentive investors will be confused by the positive profit data. In essence, it is just a mirage of profits created by corporate managers. After the reality emerging, investors will eventually find the illusion. Figure2 shows how one-time income masks profits.

In recent years, housing prices in Beijing, Shanghai and Guangzhou have been particularly high. By the end of the year, some listed companies started to sell houses, especially high-value properties in first-tier cities. In 2017, Beingmate had a loss of 380 million in the first three quarters and then sold 22 properties in Shanghai, Hangzhou and other first-tier cities at the end of the year. It is estimated that more than 58 million will be recovered to save the operating conditions of the company. According to the disclosure statistics of listed companies in 2017, 134 listed companies sold 220 properties, 30% of which were sold in the fourth quarter. It can be fully seen that some listed companies have already depended their operating performance on the non-operating income from the sale of real estate. This is obviously not stable. Relying on the positive financial report to attract investors will definitely expose its problem. Investors also need to carefully identify this kind of growth. After all, this kind of one-time income may cause the company to cheat and make it into operating profits, causing investors to misunderstand. But this type of income is transient and unsustainable.

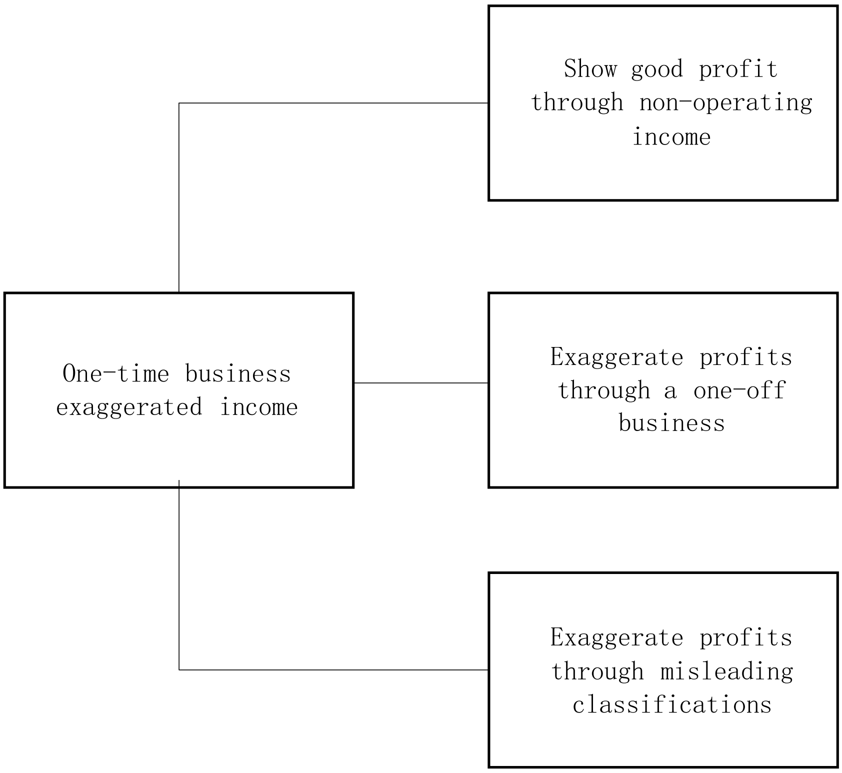

Figure 4 One-time business masks real profits

5. Countermeasures to govern manipulating earnings

5.1. Accelerate the construction of laws and regulations

Laws and regulations are time-effective. With the rapid development of the economy, accounting laws and regulations need to be improved with actual needs. For accounting behaviors that have not been fully restricted, timely accounting policies are also needed to govern. In addition, the legislature also needs to consider the cost of violating the accounting regulations. In the current situation, the punishment for accounting fraud is too light, especially when compared with the huge profits that listed companies obtain through accounting fraud.

5.2. Improve the internal control system of the enterprise

For more standardized accounting practices and higher quality information, companies must strictly promote internal control systems. In order to prevent internal incomes and expenses confusion, internal favoritism and fraud, accounting information distortion. Otherwise listed companies suffer unnecessary losses.

5.3. Improve the quality of accountants

First of all, the threshold for entering the accounting industry should be raised to confirm the optimization of talent in the accounting industry. Then, accountants should be given regular continuing education, understand the bottom line that accountants must adhere to, strengthen professional skills, and the government should increase the punishment for violations of professional ethics[6]. Promote external supervision of accountants, with clear rewards and penalties, and help reduce the occurrence of manipulating profits.

5.4. Taking advantage of public pressures

Nowadays, the role of the Internet and the media is getting more important, and we should maximize its function. Regardless of the regulatory department or the general public, when it is discovered that a company is manipulating earnings or accounting fraud, it can be exposed to the media or social networks. This type of information is related to the benefits of people and affects the trust of the company and the public. Negative information will surely stir up storms, and the companies that cause the accident will immediately be criticized by the public. The timeliness of the media can also make things ferment quickly. Companies must stand up, respond, and provide solutions as soon as they can.

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