

Case Study on Earnings Management of Listed Companies in China

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ABSTRACT

Earnings management of listed companies is a key issue in the study of business behavior. Although the research on earnings management has been going on for a long time, with the development of market economy, various problems that are not conducive to corporate profits are likely to occur in the operation of enterprises. For the purpose of avoiding delisting and other purposes, the management of enterprises will carry out earnings management by various means within the scope permitted by accounting standards to maximize profits. Under the background of market economy, the study of earnings management is of great significance to standardize the behavior of listed companies and promote the healthy development of economy. Based on the case of earnings management of YC Technology Co., Ltd., a listed company in China, this paper makes an in-depth analysis of earnings management from the aspects of motivation, means and impact by studying the annual report of the company, and provides reasonable suggestions for improving the company's profitability and promoting economic quality and efficiency.

KEYWORDS

earnings management; ST system; Non-recurring profit and loss

INTRODUCTION

Earnings management has always been a hot issue in the field of enterprise management. Earnings management, also known as profit manipulation, is an accounting choice made by enterprises from the perspective of profit maximization (Zhang, 1999). Earnings management is generally divided into accrual earnings management and real earnings management (Ma et al., 2014; Liu and Li, 2018), accrual earnings management is an enterprise's profit manipulation through accounting estimation and accounting policy selection and other means, while real earnings management refers to an enterprise's behavior of changing actual specific business activities to affect corporate profits and cash flow, so as to whitewash performance and other purposes (Yan and Zhou, 2023).

At present, the theoretical research on earnings management is rich and involves many aspects. These studies include the motivation, means and economic consequences of earnings management. The company's earnings management has external conditions, namely the flexibility of ST system, and the company has the opportunity to improve its performance in one year. Based on a company's actual operation and profitability, its motives for earnings management include avoiding delisting. It is generally believed that companies with delisting risks are more likely to use more earnings management (Cheng P. et al., 2010; Yin, 2023), including loss reversal motive (Zhang and Yang, 2007), profit smoothing motive (Wei et al., 2007) and reward motive (Luo et al., 2016; Xu and Li, 2023). In addition, it also includes the motivation of private placement of new shares. Before private placement of new shares, enterprises are likely to carry out earnings

management, and the degree is closely related to the shareholding ratio of the largest shareholder (Zhang, 2010).

The study of earnings management also involves some relatively new fields, such as analyst tracking and corporate earnings management (Li et al., 2014), the connection between language and earnings management (Kim J. et al., 2017), the impact of online media reports on earnings management (Wang et al., 2021), the impact of kinship on earnings management (Tan et al., 2022) and the impact of corporate credit rating downgrade on earnings management (Koerniadi H., 2023).

The purpose of earnings management is different for enterprises, which may be related to their own operating conditions or managers' ideas. To study the motivation and means of earnings management is helpful to improve the judgment and application ability of corporate information. Analyzing earnings management behavior through specific cases can help investors deepen their understanding of earnings management in a more intuitive way and safeguard their own economic interests. Corporate earnings management behavior is concealment, which is extremely unfavorable to the long-term development of enterprises, and even affects the healthy development of the whole market economy. It is of great theoretical and practical significance to study and identify the earnings management behavior of enterprises.

RESEARCH METHODS

Case analysis method is the main method used in this paper. Case analysis generally refers to the method of selecting a specific and representative case for discussion and research on the basis of fully collecting relevant information and understanding the nature of the problem after determining the research topic, so as to draw deeper conclusions and obtain enlightenment. Focusing on the earnings management of listed companies, this paper selects YC Technology Co., Ltd. as the object of analysis, conducts research from various aspects and dimensions such as motivation and means, and clarifies the actual situation and subsequent impact of earnings management by analyzing the company's financial data and relevant information.

Company Profile

YC Technology Co., Ltd. was founded in 1997 and listed on the Shenzhen Small and Medium Board in June 2010 as the first share of China industrial design. The company adheres to the core values of "customer-centric, striving for innovation, pursuing excellence" and adheres to the mission of "innovative design, creating the future with wisdom". The main business of the company is industrial Design, with a distinctive innovative industrial model - DMS (Design & Manufacture & Services) model, guided by industrial design, mold development, IML injection molding, two-color injection molding, precision injection molding, sheet metal stamping, spray assembly, etc. Provide industrial design services for customers in various industries such as new energy, automobiles, smart home appliances, and medical health. The company has more than 10 wholly-owned or majority-owned subsidiaries.

Risk Warning

According to Article 13.2.1 of the Shenzhen Stock Exchange Listing Rules (Revised November 2018), if the audited net profit of a listed company in the last two fiscal years has been continuously negative or the net profit in the last two fiscal years has been continuously negative due to retroactive restatement, then the stock exchange has the right to impose a delisting risk warning on its stock trading. Since the company's audited net

profit in 2017 and 2018 was negative for two consecutive years, in accordance with the regulations, the company's stock trading was suspended for one day on April 29, 2019, and after the resumption of trading on April 30, 2019, it was implemented a "delisting risk warning" special treatment, and the "*ST" logo was added before the company's stock name. In 2019, the company's net profit turned positive at ¥134,138,240.61, while the net profit attributable to shareholders of the listed company before non-recurring gains and losses remained negative at ¥-129,963,574.00 (Table 1). The large difference between the two indicates that the company's non-recurring profit and loss is too large, and the company is most likely to carry out earnings management.

One of the reasons for choosing this company as a case is that the current year is January 2024, and we can at least obtain the annual reports and other relevant documents disclosed by the company in 2022 and years up to 2022, so that we can understand and analyze the performance and development of the company after earnings management.

Table 1. Net profit of YC Technology Co., Ltd. from 2016 to 2020

Year	2016	2017	2018	2019	2020
Net profit attributable to shareholders of listed companies (Unit: ¥)	19,205,163.24	-478,527,643.84	-813,674,954.32	134,138,240.61	65,845,435.23
Net profit attributable to shareholders of listed companies after deducting extraordinary gains and losses (Unit: ¥)	-16,332,823.96	-512,478,549.66	-810,006,179.1	-129,963,574.00	35,851,160.52

RESULTS AND DISCUSSION

Motivation analysis of earnings management—based on YC Technology Co., Ltd.

1. Motivation of avoiding delisting

According to Article 14.1.1 of the Rules for Listing Stocks on the Shenzhen Stock Exchange (Revised November 2018), if the audited net profit of a listed company in the last two fiscal years is continuously negative, the audited net profit of the listed company in the first fiscal year after the delisting risk warning is implemented continues to be negative. The stock exchange then has the power to suspend trading in its shares. Due to the special treatment of "delisting risk warning" for YC Technology Co., Ltd., according to the regulations, if the company's audited net profit in the fiscal year 2019 continues to be negative, the company will be suspended from listing, and the company wants to apply for listing again after being suspended, and the standard it faces is very high. If an enterprise is suspended from listing, on the one hand, all the costs paid by the enterprise for listing in the early stage will almost lose meaning, on the other hand, it will undoubtedly have a great adverse impact on the future development of the company, resulting in limited financing channels, business difficulties or reputation decline and other adverse consequences, involving the interests of various parties. For the management of the company, delisting of the company will also lead to the loss of its interests. In the short term, it is obviously unrealistic to reverse the loss by improving the operating performance. In this case, the company has a strong incentive to make timely adjustment to the profit through earnings management to avoid the incalculable loss caused by the delisting of the company.

2. Motivation of smoothing the profit

It has always been the core goal of listed companies to keep their profits in a stable and high level for a long time, which is of vital significance to enhance investor confidence and enhance enterprise value. Throughout the financial situation of YC Technology Co., Ltd., although its net profit has shown a not optimistic trend since 2011-specifically, it has dropped from 147 million yuan in 2010 to 37.16 million yuan in 2011, and has been maintained at a similar low level until 2016, except for 2013, Net profit did not fall sharply and was generally stable. The sharp decline in YC Technology Co., Ltd. net profit in 2017 and 2018 will reduce investors' trust in the company and cast doubt on the company's long-term profitability.

3. Motivation of executive

Senior executives are the decisive factor of corporate governance and play an irreplaceable role in overall strategic planning, business strategy, cost management, product production and marketing. The decisions of senior executives affect the overall development direction of the company and the specific daily business activities. From the perspective of company executives, the motivation of earnings management of listed companies can be divided into two aspects.

One is executive pay. In many companies, executive pay is tied to performance. Obviously, the performance of senior executives is mostly reflected in their own effective contributions to the company, that is to say, if the company's profitability and market recognition can reach a good level under the management of senior executives, then the performance of senior executives is excellent. The high efficiency of the company means the high compensation of the executives. Based on this, the company's management is willing to improve the company's operating capacity and profitability through their own efforts to increase personal income; In the case of poor business performance of the company, senior managers will have the motivation to carry out earnings management and manipulate profits by various means to whitewash the company's performance and avoid a significant reduction in compensation.

The other is protecting the reputation of individual executives. As the important decision makers of the enterprise, the senior managers affect all aspects of the enterprise operation. In addition to the uncontrollable market factors, the level of corporate profitability reflects the personal ability of managers to a large extent. A well-run enterprise cannot be separated from the management personnel's far-sighted strategic planning and reasonable production and sales strategies. If an enterprise encounters operational difficulties or even faces the risk of delisting, it will inevitably make stakeholders doubt the ability of the management, which will have a negative impact on the personal reputation of the managers and even affect their future career.

Based on the above reasons, senior executives have great motivation to carry out earnings management to safeguard their personal interests, and the impact of senior executives' subjective factors on earnings management cannot be ignored.

4. Motivation of financing and maintaining stock prices

Financing is crucial for enterprises, which can enhance the ability of enterprises to create value, and can help enterprises to withstand external risks to a certain extent. Once the enterprise is implemented "delisting risk warning", it indicates that the company's operation has encountered major problems, which will make the outside world doubt the sustainable operation ability of the enterprise, and adopt a more cautious attitude toward the company. In order to avoid risks and reduce losses, external investors are likely to reduce their investment in the company or even stop investing in

the company in the short term, which will cause the company's financial financing difficulties or even capital chain break, and have an adverse impact on cash flow. For banks and other institutions, companies that have been "delisting risk warning" may have the risk of debt repayment difficulties, so banks and other institutions will be more stringent standards for companies to issue loans, which will make it more difficult for companies to obtain loans.

To a large extent, the implementation of "delisting risk warning" will reduce investors' trust in the company, and some shareholders will sell their shares, which will lead to a decline in stock prices or abnormal fluctuations.

In order to ensure the long-term safe operation of the capital chain and reduce the losses caused by falling stock prices, YC Technology Co., Ltd. has the motivation to carry out earnings management, so as to avoid the delisting of the enterprise, minimize the damage to the interests of the enterprise, and provide financial support for the enterprise to restore production capacity, improve technology and expand sales channels.

The means and effects of earnings management

1. Profit or loss on the disposal of non-current assets

By studying the annual report of YC Technology Co., Ltd., it can be learned that the company's net profit from 2013 to 2018 showed a trend of fluctuation and decline, indicating that the company's business situation in recent years is not optimistic. However, in 2019, the company turned its net profit from loss to profit, rising from -816 million yuan to 134.4 million yuan. One of the main reasons for this change is that the company made large asset disposals in 2019. As can be seen from the notes to the company's financial statements, in 2019, the company will be located in Guangzhou Development Zone, No. 29 Kefeng Road land use rights and plant, Chongqing Design Valley Technology Co., Ltd. 100% equity, Hefei Jianghuai Yichang Auto Trim Co., Ltd. consisting of assets package listed and transferred. The transaction increased the company's total annual profit of 152,311,334.20 yuan in 2019, which played a crucial role in the increase of net profit.

Wuxi Jinyue Technology Co., Ltd. is a subsidiary of YC Technology Co., Ltd. YC Technology Co., Ltd. holds 75% of its equity. The net profit of the subsidiary in 2017 was -56,2508.26 yuan (audited). From January to September 2018, the operating income was 0 and the net profit was -290,133.63 yuan (unaudited). The operating condition is poor. At the beginning of 2019, YC Technology Co., Ltd. decided to cancel its subsidiary Wuxi Jinyue Technology Co., Ltd., although the company has not been given a delisting risk warning at this time, the cancellation of the poorly operated subsidiary is undoubtedly beneficial to YC Technology Co., Ltd. to reduce costs and turn losses into profits.

2. Reserve for impairment

When a company is faced with a significant decline in net profit, it is likely to take a large amount of asset impairment losses in the previous year and reverse them in the current year to increase the current year's profit. Further review of the annual report of YC Technology Co., Ltd. shows that the company made a large asset impairment loss in 2018 and reversed it in 2019, making an important contribution to improving the company's performance. The data show that the company has an important amount of bad debt reserve recovery or repatriation in 2019, namely a bank deposit of 90,316,877.64 yuan obtained from Lerong New Electronic Technology (Tianjin) Co., Ltd. The above matters have played a role in promoting the company's turnaround.

3. Government subsidies

Obtaining government subsidies is one of the important means for enterprises to alleviate operating difficulties and avoid delisting. Enterprises can promote the development of local economy by paying taxes and providing employment opportunities, etc. Once delisting, it will also have a negative impact on the regional economy to a certain extent. Therefore, the government is willing to provide reasonable help for the development of enterprises through government subsidies and other ways.

Through studying the annual report of YC Technology Company, it can be seen that in 2019, the company received 35,041,083.42 yuan of government subsidies and included them in the current profit and loss, and 2,116,250.00 yuan of government subsidies were included in non-operating income, which provided a great boost to the improvement of net profit. Government subsidies in 2019 undoubtedly play a positive role in improving performance. However, data show that the company has been receiving government subsidies for a long time and the amount peaked from 2017 to 2019 (Table 2), while the company still had a negative net profit during this stage, which is enough to indicate that the company's operation has major problems. Companies relying on government subsidies cannot fundamentally improve operating performance and profitability.

Table 2. Government subsidy amount of YC Technology Co., Ltd. from 2016 to 2020.

Year	2016	2017	2018	2019	2020
Government grants recognised in profit or loss for the current period (Unit: ¥)	28,322,849.81	41,418,251.17	36,129,961.93	35,041,083.42	31,937,319.58

CONCLUSION

Through the analysis of the annual report of YC Technology Co., Ltd., it can be learned that YC Technology Co., Ltd. achieved a profit in 2019 through earnings management, which avoided the risk of delisting to a certain extent, which is of great significance to the long-term operation and development of the company. In the disclosure announcement on July 16, 2020, the company said that due to achieving profit in 2019, the company had applied to the Shenzhen Stock Exchange for "ZhaiMao"(in other words, apply to revoke the delisting risk warning), and the Shenzhen Stock Exchange decided to revoke the "delisting risk warning" for YC Technology Co., Ltd. from July 23, 2020. However, in view of the weak profitability of the company's main business and the low total net assets, the company's shares were issued "other risk warnings" by the Shenzhen Stock Exchange. It can be seen that the Shenzhen Stock Exchange is still more cautious about the company's long-term profitability.

As can be seen from the company's financial data from 2018 to 2022 (Table 3), the company's operating income has shown a trend of fluctuation and decline in recent years, and the decrease is relatively large, as low as 2,710,971,460.67 yuan in 2022. Although operating costs show a fluctuating downward trend from 2018 to 2022, it can be seen that the difference between operating costs and operating income is not large, which means that the operating performance of enterprises is at a low level for a long time. As can be seen from the main business data in Table 3, although most of the operating income is contributed by the main business income, the amount of the main business income is higher than the main business cost is small, and the company's main business income is

low, which is still a huge challenge for the long-term development of the enterprise. Although YC Technology Co., Ltd. has avoided the risk of delisting through earnings management, it has not fundamentally improved the company's profitability.

Table 3. Operating income and operating cost, main business income and main business cost of YC Technology Co., Ltd. from 2018 to 2022.

Year	2018	2019	2020	2021	2022
Operating income (Unit: ¥)	4,899,126,828.89	3,514,813,978.31	3,063,213,119.75	3,744,353,273.28	2,710,971,460.67
Operating cost (Unit: ¥)	4,653,193,717.05	3,147,528,198.47	2,711,629,678.45	3,353,684,841.74	2,396,798,352.52
Main business income (Unit: ¥)	4,535,249,166.03	3,035,209,383.01	2,609,612,510.59	3,151,211,048.56	2,228,378,983.46
Main business cost (Unit: ¥)	4,386,740,398.78	2,707,184,497.39	2,322,463,808.99	2,805,676,769.46	1,957,396,136.29

Therefore, this paper puts forward the following suggestions based on case studies. First, for listed companies, they should focus on enhancing the profitability of their main business and improving the level of internal governance. In daily business activities, the company should improve its insight into the market, and produce and sell products according to customer needs, so as to increase the company's operating income. At the same time, we should also pay more attention to cost management, reduce costs through technological innovation, improve efficiency and reduce unnecessary expenses, fundamentally improve the company's profitability, enhance the company's core competitiveness, and reduce the risk of delisting the company. At the same time, we should pay attention to improve the internal management level of the company and perfect the internal control mechanism. Second, for investors, the interests of investors are closely related to the profitability of the company, so investors should pay attention to the operation and cash flow of the company, and pay attention to the disclosure of the company's financial data. Investors should be careful to judge whether the company's performance is due to good management and strong market competitiveness, or just because of earnings management to obtain short-term profits. Investors should think independently based on the actual situation, make rational investment decisions, and safeguard their legitimate rights and interests. Third, the relevant regulatory authorities should be fully aware that earnings management is a common means for enterprises to manipulate profits, accurately identify earnings management behaviors, strengthen the supervision of listed companies or put forward some targeted and reasonable penalties, effectively reduce the earnings management behaviors of enterprises, and promote the long-term healthy development of the market.

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