Earnings Management Methods and Market Response Strategies of Listed Companies from the Perspective of Financial Governance

Xin Yao
Jiangxi Institute of Technology, Nanchang, 330000, China
475037064@qq.com

ABSTRACT

This article, from the perspective of financial governance, delves deeply into the common means of earnings management for listed companies, including the utilization of accounting policies and estimates, related-party transactions, and non-recurring gains and losses. At the same time, analyze the negative impacts these measures have on the financial market, such as information distortion and distorted resource allocation. Furthermore, market response strategies are proposed, covering aspects such as improving the corporate governance structure, strengthening accounting standards and regulatory systems, enhancing the quality of audit supervision, and intensifying investor education, aiming to provide theoretical support for maintaining the stability of the financial market and promoting the rational allocation of resources.

Keywords: Financial governance; Listed company; Earnings management measures; Market response strategy.

1. INTRODUCTION

With the continuous development and deepening of the global financial market, listed companies, as the core entities of the market economy, the authenticity and transparency of their financial information play a crucial role in maintaining market order, protecting the interests of investors, and promoting the rational allocation of resources [1]. Earnings management, as the behavior of listed companies to regulate the results of financial reports through means such as choosing accounting policies and arranging transaction timing within the framework of following accounting standards, although to a certain extent reflects the flexibility and adaptability of the enterprise management, excessive or unreasonable earnings management can distort the true financial situation of the enterprise and mislead investors' decisions. It undermines the fair competitive environment of the market and even threatens the stability of the financial market [2].

In recent years, scholars at home and abroad have continuously deepened their research on earnings management, revealing various motives, means and economic consequences of earnings management. The main motivations for listed companies to conduct earnings management include meeting regulatory requirements, catering to market expectations, avoiding tax burdens, and maximizing the interests of the management itself, etc. [3] These motives prompt enterprises to manage earnings by adjusting accounting policies, exploiting related-party transactions, manipulating non-recurring gains and losses, and other means, in order to achieve their specific purposes. However, the existence of earnings management not only harms the interests of investors but also affects the healthy development of the capital market [4].

Against this backdrop, from the perspective of financial governance, in-depth exploration of the means of earnings management of listed companies and their market response strategies is of great significance for maintaining the order of the financial market, protecting the interests of investors, and promoting the sustainable development of listed companies. This article aims to systematically sort out the main means of earnings management of listed companies, analyze the motives and economic consequences behind them, and propose corresponding market response strategies, with the expectation of providing theoretical support and practical guidance for the stable and healthy development of the financial market.

2. THE THEORETICAL BASIS OF EARNINGS MANAGEMENT IN LISTED COMPANIES

2.1 Definition and Connotation of Earnings Management

Earnings management, as an important research topic in the fields of accounting and finance, has a theoretical basis involving multiple aspects. Firstly, the economic consequences theory of accounting information holds that accounting information is not only an important basis for enterprise decision-making but also the main source of information for external stakeholders to evaluate enterprise performance and make investment decisions. Therefore, the management of enterprises has the motivation to influence the generation and disclosure of accounting information through earnings management in order to maximize their own interests [5].

Secondly, the contract theory provides theoretical support for earnings management. An enterprise is composed of a series of contracts, which stipulate the rights and obligations among its various stakeholders. Due to the incompleteness and rigidity of contracts, enterprise management often needs to rely on earnings management to deal with the constraints and uncertainties brought about by contracts [6]. For instance, debt coventry may contain restrictive terms regarding the company's financial indicators. Management may meet these terms through earnings management to avoid the cost of default.

In addition, the theory of information asymmetry and the principal-agent theory also provide important perspectives for the research of earnings management. The theory of information asymmetry points out that due to the information asymmetry between the internal management of an enterprise and external investors, the management may take advantage of this information superiority to conduct earnings management, thereby misleading investors' decisions. The principal-agent theory emphasizes that there exists a principal-agent relationship between the management and shareholders of an enterprise. The management may, for their own interests, use earnings management to embellishment financial statements in order to enhance their personal reputation and salary levels [7].

2.2 Motivation Analysis of Earnings Management

The motives of listed companies for earnings management mainly stem from multiple aspects. In terms of contractual motivation, there exists a contractual relationship between enterprise managers and stakeholders such as shareholders and creditors. To meet the performance indicators stipulated in the contract, such as the solvency indicators in debt contracts and the profit requirements in equity financing, managers may ensure the realization of their own interests through earnings management [8]. In terms of motivation, performance is an important indicator for evaluating a manager's ability and is closely related to personal prospects such as promotion and salary. Therefore, managers may enhance their performance through earnings management to obtain better career development opportunities. The economic motivation is more direct. Through earnings management, the company's market valuation is enhanced to create greater economic value for shareholders. For instance, to meet the conditions for rights issue, additional issuance and other refinancing, or to avoid risks such as stock price decline and delisting due to poor performance, enterprises will carry out earnings management.

3. COMMON METHODS OF EARNINGS MANAGEMENT IN LISTED COMPANIES

3.1 Utilize Accounting Policies and Accounting Estimates

The change in the depreciation policy for fixed assets directly affects the company's profits. When the depreciation method changes from the accelerated depreciation method to the straight-line method (in the early stage of the use of fixed assets), or from the straight-line method to the output method or workload method (when the annual output or workload decreases), as well as the extension of the useful life of fixed assets, it will lead to a decrease in the depreciation rate of fixed assets in the current period and subsequent periods, and the profit will increase accordingly. Extending the useful life of fixed assets has a relatively lasting impact on increasing profits in subsequent periods, while changes in depreciation methods have a significant impact on current profits, and listed manufacturing companies are more affected by this.

There is considerable room for earnings management in asset impairment provisions. The determination of the proportion of bad debt provisions is arbitrary. Listed companies can overestimate or underestimate it according to their own needs. The net realizable value of inventories and the recoverable amounts of long-term investments, fixed assets and intangible assets are difficult to determine, which leads to speculative behavior when making impairment provisions for these four assets. Some enterprises also abuse accounting estimates to make excessive provisions for asset impairment. They make large provisions when their performance is poor, and even recognize potential future expenses and losses in advance to prepare for turning losses into profits in the following year. When disposing of assets in subsequent years, they reverse the impairment provisions to increase profits.

In terms of revenue recognition, it is quite common to recognize revenue in advance, such as when the revenue generation process is not completed, the transaction has not occurred, or there is significant uncertainty in the future, and further services still need to be provided. Deferred recognition of revenue is used when current earnings are abundant and future earnings are expected to decline, to smooth out earnings and ensure that the company's earnings show a stable upward trend. Revenue-generating events refer to the artificial economic activities created by enterprises to increase profits, such as making a sale at the end of the year and returning it the following year, or inflating the revenue and profits in consolidated financial statements through inter-subsidiary trading transactions. There are also cases where enterprises abandon their consistent credit policies, relax credit standards, extend credit terms, and create cashless income profits regardless of risks in order to achieve profit targets. In terms of expense recognition and measurement, expense capitalization, such as the capitalization of borrowing costs, is carried out by listed companies through the abuse of the flexibility of the termination time stipulated for interest capitalization for earnings management. The deferred and early recognition of expenses take advantage of the difficulty in determining the benefit period of the expenses, and arbitrarily determine the promotion period. Hidden loss write-up refers to the situation where potential losses are not recognized, resulting in an overestimation of the book capital value and an overestimation of the current period's profit.

3.2 Utilizing Related-party Transactions

Related-party transactions are often not conducted as fair transactions due to the control relationship among related parties. The main methods include fabricating economic transactions and artificially boosting the business level and efficiency of listed companies. Conduct purchase and sale activities at a price significantly higher or lower than the market price; Make financial transactions at low or high interest rates to adjust financial expenses; Profits are adjusted by collecting or paying management fees, or by sharing common expenses, etc. Through these means, profits can be transferred between the parent company and the listed company to meet the different needs of the listed company, such as avoiding delisting and meeting the qualification for rights issue.

3.3 Utilize Non-recurring Gains and Losses

Non-recurring gains and losses refer to various incomes and expenditures incurred by a company that have no direct relationship with its business operations, as well as those that, although related to its business operations, affect the true and fair reflection of the company's normal profit level due to their nature, amount or frequency of occurrence. The means by which listed companies in China manage earnings through non-recurring gains and losses are diverse, including provisions for asset impairment, asset sale, equity transfer, asset swap, debt restructuring, tax reduction and exemption, interest reduction and exemption, and government subsidies, etc. When enterprises use non-recurring gains and losses for earnings management, it is often related to related parties or local governments, and usually large non-recurring gains and losses are recognized in a rush towards the end of the accounting year.

4. THE IMPACT OF EARNINGS MANAGEMENT OF LISTED COMPANIES ON THE FINANCIAL MARKET

4.1 Information Distortion and Misleading Investors' Decision-making

Excessive earnings management by listed companies leads to financial report information failing to truly reflect the financial status and operating results of the enterprises, making it difficult for investors to accurately understand the actual situation of the enterprises. Investors making investment decisions based on distorted information may lead to wrong investments, investing funds in enterprises with poor actual operating conditions and missing out on those with genuine development potential, which can harm their own interests and reduce the efficiency of market resource allocation.

4.2 The Destruction of a Fair Market Competition Environment

Earnings management makes enterprises present false performance on the surface, undermining the principle of fair market competition. Some enterprises inflate their profits through earnings management to gain more market resources and opportunities, such as financing convenience and policy preferences. However, truly well-performing and genuine enterprises may be at a disadvantage in market competition due to the lack of earnings management, which is not conducive to the functioning of the market's survival of the fittest mechanism and hinders the healthy development of the financial market.

4.3 The Stability of the Financial Market is Threatened

The earnings management behaviors of a large number of listed companies will cause confusion in market information and increase market uncertainty. When earnings management practices are exposed or market expectations regarding earnings management change, it may trigger stock price fluctuations, even leading to market panic and affecting the stability of the financial market. In particular, some enterprises engage in excessive earnings management to meet specific purposes. Once this cannot be sustained, they may face problems such as a significant decline in performance and financial difficulties, which in turn can trigger a chain reaction and pose a threat to the stability of the financial market.

5. STRATEGIES FOR THE MARKET TO DEAL WITH EARNINGS MANAGEMENT OF LISTED COMPANIES FROM THE PERSPECTIVE OF FINANCIAL GOVERNANCE

5.1 Improve the Corporate Governance Structure

The equity structure of listed companies in China is complex, with prominent problems such as an excessively high proportion of state-owned shares and excessive equity concentration, which can easily lead to insider control and provide fertile ground for earnings management. The equity structure should be optimized through measures such as reducing state-owned shares and introducing strategic investors to form a diversified equity balance pattern, reduce the control of a single shareholder, enhance the scientific and democratic nature of the company's decision-making, and curb earnings management behavior.

Independent directors play a balancing role in corporate governance, but the independent director system in China has problems such as insufficient independence and inadequate performance of duties. The selection and appointment mechanism for independent directors should be improved to ensure their independence, clarify their responsibilities and rights, establish an assessment and evaluation mechanism as well as an incentive and restraint mechanism for independent directors, enhance their enthusiasm and sense of responsibility in performing their duties, and give full play to their supervisory role.

Establish an audit committee within the company to be responsible for the audit and supervision of the company's financial activities. The Audit Committee should be headed by an independent director, and its members should possess professional financial knowledge and auditing experience. The Audit Committee regularly audits and assesses the company's financial reports, internal controls, etc., promptly discovers and corrects violations such as earnings management, and promotes the improvement of the company's internal control system.

5.2 Strengthen Accounting Standards and Regulatory Systems

The department formulating accounting standards should further revise and improve the enterprise accounting standards, reduce ambiguous language and concepts in the standards, and narrow the range of accounting policies and methods available for selection. Make uniform regulations on the same business in different industries and classify the business held by enterprises of different industries or scales, so as to make the application of standards by enterprises more targeted and reduce the space for earnings management. At the same time, the mandatory disclosure requirements for projects that may undergo earnings management should be strengthened to enhance information transparency.

Improve the qualification control parameters for additional share issuance and rights issue, establish a more scientific indicator system, and prevent managers from manipulating profits due to a single indicator. Further improve the delisting system, increase the flexibility of the evaluation criteria for ST and delisting, and add more evaluation standards reflecting the cash flow of enterprises, so as to more comprehensively reflect the financial status and sustainable operation ability of enterprises. Strengthen the supervision over the information disclosure of listed companies, increase the penalties for illegal information disclosure, raise the cost of violations, and form an effective deterrent.

5.3 Enhance the Quality of Audit Supervision

Accounting firms, as third-party auditing institutions, bear the responsibility of verifying the authenticity of accounting information. It is necessary to strengthen the education on professional ethics and professional training for certified public accountants, enhance their risk awareness and practice level, and improve their ability to audit the profit quality of listed companies. During the auditing process, certified public accountants pay special attention to the abnormal fluctuation of working capital items and abnormal accrual income items in the income statement of listed companies, obtain sufficient and appropriate audit evidence, and evaluate the rationality of the accounting treatment methods and the sufficiency of disclosures of the audited enterprises.

The Institute of Certified Public Accountants should strengthen self-discipline management within the industry, formulate strict industry norms and professional ethics standards, enhance the inspection and supervision of the practice quality of accounting firms and certified public accountants, and deal with violations seriously. Meanwhile, government regulatory authorities should strengthen supervision over accounting firms, establish and improve regulatory mechanisms, standardize the auditing practices of accounting firms, and enhance the overall quality of the auditing market.

5.4 Strengthen Investor Education

Investors are important participants in the financial market, and their investment decisions directly affect the efficiency of market resource allocation. Investor education should be strengthened to enhance their professional analytical capabilities, enabling them to identify the earnings management behaviors and their extent of listed companies. By holding investment knowledge lectures, training courses and other forms, financial knowledge, investment skills and risk prevention awareness are popularized among investors, guiding them to establish a rational investment concept and avoid blindly following the trend in investment.

Institutional investors, with their professional investment teams and strong research and analysis capabilities, play a significant role in market stability. We should actively cultivate institutional investors, encourage long-term funds such as pension funds and insurance funds to enter the market, and increase the proportion of institutional investors in the market. Institutional investors' participation in market investment can leverage their professional advantages to effectively supervise and restrict the earnings management behaviors of listed companies, promoting the stable and healthy development of the market.

6. CONCLUSION

Earnings management behavior of listed companies is widespread in the financial market. Its means are diverse and it has many negative impacts on the financial market, such as information distortion, undermining the fair competitive environment, and threatening market stability. From the perspective of financial governance, through market response strategies such as improving the corporate governance structure, strengthening accounting standards and regulatory systems, enhancing the quality of audit supervision, and intensifying investor education, it is possible to effectively curb the earnings management behavior of listed companies, improve the quality of financial information, maintain the stability of the financial market, promote the rational allocation of resources, and drive the healthy and sustainable development of the financial market. In the future, as the financial market continues to develop and innovate, the earnings management methods of listed companies may become more concealed and complex. It is necessary to constantly strengthen the research and practice of financial governance and continuously improve the response strategies to adapt to the changing demands of market development.

REFERENCES

[1] Hu, J., Tang, Y., Yin, N., & Guo, X. (2024). Institutional investor information competition and accounting information transparency: Implications for financial markets and corporate governance in China. Journal of the Knowledge Economy, 15(2), 9629-9666.

[2] Alao, A. I., Adebiyi, O. O., & Olaniyi, O. O. (2024). The interconnectedness of earnings management, corporate governance failures, and global economic stability: A critical examination of the impact of earnings manipulation on financial crises and investor trust in global markets. Asian Journal of Economics, Business and Accounting, 24(11), 47-73.

[3] Huang, H., Liu, S., Gong, Y., Yan, Z., & Ge, Z. (2025). Export control and earnings management: Evidence from China. International Review of Financial Analysis, 104341.

[4] Zhang, X., Kong, X., Zhang, Z., & Ding, Z. (2024). Creditor protection and enterprise earnings management—a test based on bond covenants. Emerging Markets Finance and Trade, 60(14), 3201-3221.
[5] Habib, A., Ranasinghe, D., Wu, J. Y., Biswas, P. K., & Ahmad, F. (2022). Real earnings management: A review of the international literature. Accounting & Finance, 62(4), 4279-4344.
[6] Utari, C., Manalu, M. W., Lubis, N. R., & Muda, I. (2023). Approaches and critiques of Positive Accounting Theory (PAT) and Normative Accounting Theory (NAT): a literature review. Brazilian Journal of Development, 9(12), 31784-31799.
[7] Dong, J. Q., Karhade, P. P., Rai, A., & Xu, S. X. (2021). How firms make information technology investment decisions: Toward a behavioral agency theory. Journal of Management Information Systems, 38(1), 29-58.
[8] Bansal, M. (2024). Earnings management: a three-decade analysis and future prospects. Journal of Accounting Literature, 46(4), 630-670.