

REVIEW OF LITERATURE ON MANAGEMENT OF EARNINGS IN THE CORPORATE SECTOR

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Abstract: The aim of this paper is to examine the findings of the existing empirical studies on the above-mentioned issues of earning management decisions so as to find their answers. The research studies reviewed herein have been sourced from various national and international journals on the subject under reference and libraries of high repute in India, besides various web sites. On account of the subject ‘corporate finance’ being highly important, we find very comprehensive works on its various aspects in both advanced as well as emerging economies of the world. Hence it was not possible to make review of each and every available study. So, we have resorted to a review of selected studies. Only those studies are covered which are most often quoted in the books, doctoral theses and research journals concerning financial economics.

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Introduction: In recent years, earnings management, as a hotspot in financial accounting research, has received widespread attention from Chinese and foreign scholars. In response to this problem, Chinese and foreign scholars have conducted empirical research in various aspects, and have made some research results worthy of attention. However, although some research results of empirical accounting scholars on earnings management objectively reveal some regular phenomena in this field, so far no consensus has been reached on issues of general significance. There are many different opinions on the concept of earnings management in the accounting field, and they can be divided into two categories. The first is that American accountant William R. Scott argued in his “Financial Accounting Theory” that earnings management means that, within the scope permitted by GAAP, the choice of accounting policies enables the operator’s own interests or the enterprise. The act of maximizing market value. On the other hand, Katherine Schipper, an American accountant, believes that earnings management is actually a “disclosure management” in which corporate managers purposefully control the external financial reporting process to obtain certain private benefits. Accounting information is the cornerstone of the operation of the capital market. With the gradual development of China’s capital market, the quality of accounting information has also received increasing attention from investors and regulatory authorities. Especially after the introduction of equity incentives, because

management compensation is closely related to company performance, it often controls earnings for personal benefits, reducing the authenticity of accounting information, which not only affects the long-term development of the enterprise, but also causes economic losses to investors. In order to ensure the stability of the capital market, the academia and the physical world have always paid enough attention to the issue of earnings management. Therefore, this article will review the academic research results of 6 top journals on earnings management in China from 2015 to 2019. Firstly, I will sort out the relevant literature and classify the article according to the research theme. Secondly, I can find out the current factors affecting earnings management and the possible economic consequences of earnings management and the role of earnings management as an impact path through analysis while exploring the development of earnings management issues in China. Finally, this article discusses the development trend of China’s earnings management issues and puts forward constructive opinions on China’s future earnings management research.

All the business concerns are established to earn profits. The foremost duty of an enterprise is economic performance, which means the preservation and increase in the value of economic resources entrusted to it. To achieve this objective, the enterprises must earn profit at a certain minimum rate. The rate of profit is regarded as an indicator of the progress of the enterprise and of the direction in

which the company's resources are utilized. Profit must also provide economic growth and development. According to Peter Drucker, the profit of the concern should be sufficient to cover: (i) Current cost of business; (ii) the future cost of staying in the business due to certain risk; (iii) to fill dry holes, as the productive well must compensate the loss of pipe and labour wasted in dry hole; and (iii) to bear the social burden. The cost of social security must be met out of the profits of successful concerns. The social burden includes defence, civil administration, health services, education relief, old age benefits etc. Profits are of special significance to joint stock companies where owners and management are different entities. In case of sole proprietorship and partnership where owner always remain in touch with the firm, they remain in possession of the profits and control them. Being ultimately responsible for these profits and being at the helm of affairs, management of earnings is no problem for them. But in case of joint stock companies where ownership and management are in different hands, management of earnings assumes special importance. Generally, it happens that the companies do not pay the whole amount of earned profits to the shareholders by way of dividends but retain a portion of the profits for the rainy days and reinvest them in the business. The way a company reinvests or manages to reinvest the retained earnings is called 'Management of Earnings'.

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The function of accounting is to provide credible information to investors and stakeholders, so they can make assertive decisions. However, managers use accounting opportunistically by manipulating accounting numbers (Scott, 2012). It is type of manipulation is called earnings management, which is a practice that can be explained by agency theory, since managers could make decisions in their own interest instead of maximizing decisions for the benefit of investors (Jensen & Meckling, 1976). According to McVay (2006), the literature commonly adopts two concepts of earnings management: by accruals and by operational activities. However, the author proposes a new approach of earnings management, which verifies when there is a deliberate change in the classification of items in the income statement for the year, which is defined as classification shing. is type of earnings management differs from the others because it does not change net income (McVay, 2006). According to the literature, managers manipulate results by changing their

classification when they change, for example, normal expenses as unusual, special, significant, exceptional, abnormal or extraordinary items. These items are considered transient, non-persistent and nonrecurring. Although the magnitude of the profit is not affected, the misclassification of expenses is misleading to users of the financial statements, as different components of the income statement have different informational content that is relevant to profitability or profit forecasting. Incorrect classification of expenses is misleading to users of the financial statements because different components of the income statement have different informational content that is informative for assessing profitability or predicting future earnings. e large presence of earnings management and the low level of information are characteristic of countries with low investor protection (DeFond et al., 2007; Leuz et al., 2003), suggesting that, in countries such as Brazil, the earnings management by classification shing could be frequent. In order to mitigate this problem, the literature points out that reputation (Cao et al., 2012; Garrett et al., 2014), corporate social responsibility (Hong & Andersen, 2011, Kim et al., 2012), culture (Elias, 2004; Hashim, 2012) and corporate governance (González & García-Meca, 2014; Shen & Chih, 2007) would be factors capable of decreasing the managers' engagement in opportunistic earnings management practices.

Krishnamurty and Sastry (1979) tested an equation in which dividends were expressed as a function of gross income net of taxes, lagged dividends investment expenditure (gross fixed + inventory investment) and the flow of external debt. They used alternative set of data – (a) a pooled cross section of about 360 companies covering the years 1961-62 through 1967-68, (b) time series RBI data, as well as (c) micro, firm-wise time series data; all the three sets pertaining to seven major industries: Cotton textiles, jute, sugar, paper and paper-board, chemicals, engineering, and cement. They found that in five out of seven industries, the impact of investment that even current profits were not significant in three industries: Sugar, paper and paperboard, and cement. This study also observed that, —investment expenditure has a depressing effect on dividend dispersals in the same industries where external finance has a supporting (positive) influence. Bhole (1988) examined a inter-company differences in the level of savings and changes in that level over the period of time, (b) the determinants of saving ratio of the companies, (c) the extent of stability of dividends

paid by the companies, and (d) the relative influence of earnings and dividends on share prices. And found that the level of saving ratio of companies depends upon the type, size, and industry of the company. Large companies have a higher saving ratio than small companies; public limited companies had a higher saving ratio than that of private limited companies till the middle of the 1960s after which the saving ratio of the latter group of companies has exceeded that of the former. Chay and Jungwon (2016) examined the worldwide firm-level data, to know that the, cash-flow uncertainty is an important cross-sectional determinant of corporate payout policy. And found that, across countries, cash-flow uncertainty (represented by stock return volatility) is a key factor that affects the amount of dividends as well as the probability of paying dividends. The impact of cash-flow uncertainty on dividends was found generally stronger than the impact of other potential determinants of payout policy - such as the earned/contributed capital mix, agency conflicts, investment opportunities, firm size, and profitability. Furthermore, it was found that the cash-flow uncertainty also has a significant impact on the amount of total payouts (i.e., the sum of dividends and repurchases). Wissal, (2016) examined, the determinants of dividend payment lag for a sample of 32 Tunisian firms listed on the Tunisian financial market and observed over the period 1994-2004. and found that the timing of dividend payment was positively related to two determinants of the life cycle theory - size and liquidity - but is negatively related to benefits and growth opportunities. And also suggests that the financial firms pay dividends before industrial firms, which may be important to investors.

There are many factors that affect earnings management. Domestic scholars have analyzed and studied internal and external factors from different perspectives. Gong et al. (2015) research the asymmetry of changes between accrued earnings management and true earnings management, which results in changes in the overall amount of earnings management. Chen & Chen (2018) found that when local leaders change and policy uncertainty arises, local listed companies will increase the degree of earnings management. Zhang et al. (2015) through empirical tests found that a good financial ecological environment helps to restrain commercial banks from using loan loss provisions to perform earnings smoothing. Li et al. (2016) found that analysts' tracking of accrued earnings management has a supervisory effect while it has a positive response to

true earnings management. Research by Zhao et al. (2016) shows that joint ventures with stronger individualism in the investing country tend to conduct more upward and downward earnings management. Xie et al. (2016) found that the degree of regional competition in commercial banks will affect the bank's earnings quality. Zhang et al. (2016) found that the possibility of financial restatement is significantly lower than that of a company that cannot be sold short.

Bhayani (2017) examined the dividend payout policy in Indian corporate sector. BSE Sensex-30 companies were analyzed. To study the impact of profitability, liquidity and size of business on dividend payout. It was found that the dividend policies of the Indian companies were highly influenced by profitability and liquidity. Hardin and Hill (2016) examined the determinants of excess dividend payments above mandatory reduced agency costs, strong operating performance, the implementation of a stock repurchase plan and an ability to access short-term bank debt. And also found that access to external capital is essential for long-term growth, and suggested that REITs should manage dividend policy to allow for capital acquisition in the form of both equity and debt. Malkawi (2016) examined the determinants of corporate dividend decisions of publicly quoted companies in Jordan as a case study of an emerging market. The analysis was based on 15-year unbalanced panel data with 1137 firm-year observations covering the period between 1997 and 2011. And found that the factors that affect dividend policy in developed stock markets seem to apply for this emerging market, factors such as size, profitability, and age increase the likelihood to pay dividends. Financial leverage decreases the probability to pay dividends. Taken together, the findings provide support for the agency costs hypothesis and are broadly consistent with the pecking order hypothesis. Poterba, James and, Lawrence (2016) examined the effects of dividend taxes on investors' relative valuation of dividends and capital gains. For this purpose they used, daily data on a small sample of firms, and monthly data on a much broader sample, and found clear evidence that taxes change equilibrium relationships between dividend yields and market returns. Denis and Osobov (2015) examined the determinants of dividend in the U.S., Canada, U.K., Germany, France, and Japan. And found that the propensity to pay dividends is higher among larger, more profitable firms, and those for which retained earnings comprise

a large fraction of total equity. Although there are hints of reductions in the propensity to pay dividends in most of the sample countries over the 2002 to 2010 period, they were driven by a failure of newly listed firms to initiate dividends when expected to do so. Dividend abandonment and the failure to initiate by existing non payers are economically unimportant except in Japan. Moreover, in each country, aggregate dividends have not declined and was found concentrated among the largest, most profitable firms. Propensity to pay dividends. Overall, these findings cast doubt on signaling, clientele, and catering explanations for dividends, but support agency cost-based lifecycle theories. Kowalewski, Stetsyuk and Talavera (2015) examined the determinants of the dividend policy in Poland and test whether corporate governance practices determine the dividend policy in the non-financial companies listed on Warsaw Stock

Li et al. (2018) found that social security funds can promote the improvement of listed companies' earnings. Research by Li & Jia (2019) found the fiscal "provincially administered counties" reform can inhibit the earnings management behavior of enterprises in county jurisdictions. He's (2016) analysis shows that deferred executive compensation has reduced the volatility of bank earnings while enhancing its motivation for earnings management through LLP. Research by Chen & Xu (2019) shows that rent-seeking companies have incentives to manipulate accounting information and reduce the quality of financial reports. Lu & Hu (2015) found that non-executive directors have a significant inhibiting effect on the management of earnings smoothing. Wei & Chen (2015) found that family business CEOs will use earnings management more before leaving office. Sun et al. (2016) found that company strategy has a significant impact on earnings management. Huang et al. (2016) found that the reputation of the independent director of the accounting of private enterprises has a positive impact on the earnings quality. Liu et al. (2016) found that the order of the three methods of earnings management is significantly different due to the different types of equity held by executives. Research by Lu et al. (2017) found that an increase in the minimum wage level will significantly increase the level of accrued earnings management and true earnings management of listed companies. Tang et al. (2017) through empirical results show that the accounting surplus information content of state-owned private enterprises is significantly lower.

Kong & Liu (2017) found that companies with high participation of small and medium shareholders are more inclined to earnings management. Chen et al. (2019) found that when the company receives the inquiry letter, the earnings management behavior is suppressed. Xie et al. (2019) found those companies that have just reached the annual performance assessment are more likely to use classification manipulation in the first performance assessment year. Liu & Liu (2015) through empirical tests found that after the exogenous event of "PM2.5 bursting" at the end of 2011 leading to significant downward earnings management for heavily polluting companies. Cai's (2015) research shows that venture capital-backed companies have a higher degree of earnings management than non-venture-backed companies when IPO. Research by Li et al. (2015) found that changes in the threshold for listed companies' additional issuance performance have weakened the control of accrual earnings management. Jiang et al. (2015) found that companies that use integrity as their corporate culture have lower levels of earnings management. Wang et al. (2015) research shows that positive earnings management and the macroeconomic growth rate have a significant positive correlation. Ye et al. (2015) thought the strategic difference is positively related to accrued earnings management and negatively related to real activity earnings management.

Desai, C.F. (2015) examined the determinants of profit repatriation policies for US multinational firms. Dividend repatriations are surprisingly persistent and resemble dividend payments to external shareholders. Tax considerations influence dividend repatriations, but not decisively, as differentially taxed entities feature similar policies and some firms incur avoidable tax penalties. Parent companies requiring cash to fund domestic investments, or to pay dividends to common shareholders, draw on the resources of their foreign affiliates through repatriations. Incompletely controlled affiliates are more likely than others to make regular dividend payments and to trigger avoidable tax costs through repatriations. The results indicate that traditional corporate finance concerns – taxation, costly external finance and agency problems – are also critical to the internal capital markets of multinational firms. Karam Pal and Puja Goyal (2015) focused on overview of the important dividend theories and identify the leading factors that determine the dividend behaviour in the corporate financial

management. They found that lagged dividend, PAT, interest are the most important factors affecting dividend decisions of the industry whereas capital expenditure is not. However, target payout ratio of the industry has decreased to 44 percent in 2005-06 from 71 percent in 1996-97. George and Kumudha (2014) examined the Dividend Policy of Hindustan Construction Company Ltd. (HCCL) and found that current year's dividend is influenced by current year's earnings per share and previous year's dividend per share (supporting Harish 2004). It is found that current year's profit is more important than previous year's dividend while deciding the dividend policy. The study also reveals that it is vital for a firm to maintain a steady growing dividend rate, which would work as a signal for investors and market Das (2014) examined the concentrates on the exercise of dividend practices followed by the associated Cement Companies Limited (ACC) in India during the period from 1985-86 to 2004-2005. And found that ACC had been pursuing conservative dividend payment policy during the stated period. Correlation coefficient results reveal negative association between liquidity and the payment of dividend per share. Coefficient of rank correlation of important accounting variables influencing dividend policy evidences high degree of positive association between them excepting a few. Sur (2013) conducted a study of Colgate Palmolive (India) Ltd. (CPIL), which shows that in pre- as liberal one although both the average of and consistency in the dividend payment of the company on a per share basis stepped down remarkably. The study also reveals the better efficiency in managing earnings as well as formulating dividend policy on the part of the company during the post-liberalization era. Tai, Liu and Wei (2013) examined the corporate dividend policy in China and found that considering the special economic structure and managerial feature in China. The managerial type was taken as the dependable variable, affected by a set of characteristics of a company's investment opportunity. And found that there seems to be a need to reform the equity structure, managerial accountability, and corporate governance of publicly traded companies in China, particularly the change in the current practice of governmental appointment of managers. Corporate governance should be strengthened to establish effective managerial accountability and incentive policy in order to improve company performance. By implementing effective corporate governance, managers are more likely to adopt dividend policy that maximizes

shareholders' wealth. Sarma and Panda (2013) examined the important dividend theories and identify the factors that determine the dividend behaviour in the corporate sector in India. For the analysis, they construct the optimal dividend equation in the form of exponential function.

Wang and Huang (2017) found that the manipulated accrued profits of application derivative companies have increased significantly. Wang & Yi (2017) found that Institutional investors can curb earnings management behavior of higher weighted companies in their portfolios. Xu & Wang (2017) found that corporate innovation was significantly positively correlated with audit quality. Du et al. (2018) found that CEO's overseas experience has a negative impact on corporate earnings management based on imprinting theory. Chen et al. (2018) found that disclosure by regulations of social responsibility has an inhibitory effect on real earnings management while voluntary disclosure has an inhibitory effect on three types of earnings management. Xu et al. (2018) found that the 2012 China delisting system reform would significantly inhibit its true earnings management. Xie & Liao (2018) found that companies with pledge of controlling shareholder equity have a higher degree of true earnings management than companies with unpledged controlling shareholder equity. Li et al. (2018) found that institutional investor research can significantly inhibit the company's accrual earnings management level and improve the quality of earnings. Studies by Cai et al. (2018) have shown that companies that use fair value measurement are more inclined to use real earnings management. Guan & Zhang (2019) found good corporate reputation can significantly inhibit for companies that have implemented positive accruals and true earnings management. Yuan et al. (2019) found that the level of upward earnings management of NEEQ companies is significantly higher than that of GEM listed companies. Zhang et al. (2019) thought that the disclosure of key audit matters has a significant impact on market-perceived audit quality. It's founded by Zhou et al. (2019) that the convenience of the independent director of the remote accounting profession has a significant positive impact on the company's earnings quality. Meng et al. (2019) found that the higher degree of social trust in the area where the CPA was born, the higher degree of earnings management of the audited listed company. Xiang and Song (2019) found that academic independent directors and their reputation

have a significant positive impact on the company's earnings quality

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