



Research on the Impact of Fair Value Measurement on Corporate Earnings Management

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Abstract. Since fair value measurement is highly subjective in terms of measurement scope, method selection, and criteria, companies can manage earnings through the choice of measurement model. This paper studies the impact of fair value measurement on corporate earnings management with a sample of A-share listed companies in Shanghai and Shenzhen from 2019 to 2022. The findings indicate that the level of fair value measurement of listed companies is positively related to both the degree of accrued earnings management and real earnings management; further research based on the nature of property rights also supports the main effect. The findings of this paper can provide insights for improving the fair value measurement methods and maintaining the fairness and transparency of the market.

Keywords: Fair value measurements, accrued earnings management, real earnings management, nature of property rights.

1 Introduction

The measurement model used in accounting plays a crucial role in determining the reliability and usefulness of financial data. Presently, enterprises increasingly adopt the accounting measurement model that considers fair value in addition to historical cost to better reflect the changing economic landscape and satisfy the requirements of the evolving capital market. The use of fair value is gaining popularity among an increasing number of countries and regions. Fair value is defined as the price agreed

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upon by buyers and sellers in a voluntary and arm's-length transaction, based on their knowledge of market conditions. Measuring fair value is crucial in assessing the market worth of a company and aiding management and investors in comprehending the enterprise's financial state and performance.

There are two different views in the academic community on the influence of the adoption of fair value measurement by enterprises on earnings manipulation. On the one hand, fair value measurement, in contrast to historical cost measurement, is known for its greater information transparency and value relevance. Consequently, it discourages earnings manipulation and management's self-interested behavior related to earnings management [1-2]. On the other hand, fair value measurement in practical application has the problems of strong subjectivity, poor operability, high information cost, etc., and the management may manipulate the surplus through the fair value measurement of non-recurring gains and losses, classification of financial assets, asset impairment and other items [3]. The majority of the available research focuses on non-recurring events related to gains and losses, encompassing alterations in fair value gains and losses, investment earnings, asset depreciation, and other similar factors. The usage of fair value metrics to analyze the impact on earnings manipulation has been studied [4]. This paper aims to address the ongoing debate in the literature by introducing a novel indicator, the ratio of the sum of assets and liabilities measured by fair value to total assets. By incorporating this indicator, the measurement of fair value becomes more comprehensive, allowing for a more objective and in-depth study. The impact of earnings management provides empirical evidence for the improvement of accounting standards.

The influencing mechanism of fair value measurement on corporate earnings management is studied by analyzing the data of Shanghai and Shenzhen A-share listed companies over the period from 2019 to 2022 in this research paper. This paper finds that the fair value measurement of listed companies has a significant positive influence not only on accrued earnings management, but also on real earnings management. Through further research, state-owned companies and non-state-owned companies are consistent with the main research conclusions.

2 Theoretical Analysis and Research Hypotheses

There are two main ways of managing surplus. One is accrued earnings management, which maximizes the value of the enterprise through the choice of accounting policies

and estimates. Generally, it merely alters the allotment of profits per time frame while having no impact on the overall sum of earnings and cash flow. Second, real earnings management, by means of asset liquidation, diminishes investment, discounted sales, and other genuine economic transactions for the purpose of manipulating profits, thereby altering the earnings distribution, surplus amount, and cash flow in a holistic manner.

Early research found that accrued earnings management is the first choice of management because it can be realized by accounting means, the operating cost is low, and the negative effect on the enterprise is small [4-5]. However, due to the continuous improvement of the investor protection system and accounting standards, the space for management to manipulate earnings through accounting methods has become smaller, so it has shifted to earnings management based on real economic business [6-7]. The study found that 78% of U.S. managers would smooth surplus through real economic operations [8]. Surplus manipulation through real economic operations is also prevalent in Chinese listed companies [9-11]. Based on the definition and research of real earnings management, it leads to deviation from optimal business activities, weakens the competitiveness of the company in the long run, and is more detrimental to the long-term interests of investors than accrued earnings management [12].

The price at which a market participant would willingly pay to acquire an asset or receive compensation for transferring a liability in a well-organized transaction taking place on the date of measurement is referred to as fair value. Scholars compared the impact of adopting two measurement models, historical cost and fair value, in the UK real estate and investment industries, and they found that the real estate industry is more susceptible to fair value measurements and that it is more likely to engage in earnings management behavior [13]. Fair value measurement can not only quickly reflect economic development, but also reflect the assets and liabilities of an enterprise at a certain moment in time, which helps practitioners make more effective accounting decisions [14]. At the same time, fair value measurements that are more closely linked to the market have high information transparency and strong value relevance, which can more comprehensively and accurately reflect the level of assets and liabilities, and have a guiding role in measuring the profitability of enterprises [15].

Based on the above discussion, it turns out that the fair value measurement model is an effective way for companies to manage their earnings. This study introduces two

research hypotheses to examine the impact of fair value measurement on corporate earnings management:

H1 : The level of fair value measurement is positively correlated with the degree of accrued earnings management.

H2 : The level of fair value measurement is positively correlated with the degree of real earnings management.

3 Research Design

3.1 Sample selection and Data Sources

The data in this paper are derived from the China Stock Market & Accounting Research Database. This study chooses the A-share listed companies in Shanghai and Shenzhen, China, as the initial research subjects for the period from 2019 to 2022, and adopts the following measures to screen the samples: excluding financial companies; remove the ST class and data missing companies; pre and post 1% indentation for continuous type variables. Finally, 8170 valid samples were obtained.

3.2 Variable Setting

3.2.1 Dependent Variable

(1) Accrued earnings management

The dependent variable of this paper is the degree of earnings management of listed companies. In the Chinese stock market, the modified Jones model performs better [16]. Therefore, this paper refers to the Jones model modified by Dechow to gauge the level of accrued earnings manipulation of listed companies, the model is (1) - (3).

$$\frac{TA_{i,t}}{A_{i,t-1}} = \beta_0 \frac{1}{A_{i,t-1}} + \beta_1 \frac{\Delta REV_{i,t}}{A_{i,t-1}} + \beta_2 \frac{PPE_{i,t}}{A_{i,t-1}} + \varepsilon_{i,t} \quad (1)$$

$$NDA_{i,t} = \beta_0 \frac{1}{A_{i,t-1}} + \beta_1 \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} + \beta_2 \frac{PPE_{i,t}}{A_{i,t-1}} \quad (2)$$

$$DA_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - NDA_{i,t} \quad (3)$$

where subscripts i, t denote listed company i in year t , respectively. $TA_{i,t}$ is total accrued profit, which is obtained by subtracting net cash flow from operating activities from operating profit; $NDA_{i,t}$ is non-manipulated accrued profit; $DA_{i,t}$ for manipulated accrued profits; $\Delta REV_{i,t}$ for the change in operating income; $\Delta REC_{i,t}$ is the amount of changes in accounts receivable; $PPE_{i,t}$ is the net fixed assets; $A_{i,t-1}$ is the value of total assets at the end of the previous year. Regressing equation (1) based on industry and year, the regression coefficient is obtained and subsequently utilized in equation (2) to get NDA , and then substituted into equation (3) to get DA .

(2) Real earnings management

In this paper, we refer to Dechow, Roychowdhury model to calculate the real earnings management of firms, which is modeled in equations (4)-(7).

$$\frac{CFO_{i,t}}{A_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{A_{i,t-1}} + \alpha_2 \frac{REV_{i,t}}{A_{i,t-1}} + \alpha_3 \frac{\Delta REV_{i,t}}{A_{i,t-1}} + \varepsilon_{i,t} \quad (4)$$

$$\frac{PROD_{i,t}}{A_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{A_{i,t-1}} + \alpha_2 \frac{REV_{i,t}}{A_{i,t-1}} + \alpha_3 \frac{\Delta REV_{i,t}}{A_{i,t-1}} + \alpha_4 \frac{\Delta REV_{i,t-1}}{A_{i,t-1}} + \varepsilon_{i,t} \quad (5)$$

$$\frac{DISEXP_{i,t}}{A_{i,t-1}} = c_0 + c_1 \frac{1}{A_{i,t-1}} + c_2 \frac{REV_{i,t-1}}{A_{i,t-1}} + \varepsilon_{i,t} \quad (6)$$

$$REM_{i,t} = (-1)A_CFO_{i,t} + A_PROD_{i,t} + (-1)A_DISEXP_{i,t} \quad (7)$$

Where $CFO_{i,t}$ is net operating cash flow; $A_CFO_{i,t}$ is abnormal cash flow from operating activities; $PROD_{i,t}$ is cost of production, equal to the sum of operating costs and change in inventory; $A_PROD_{i,t}$ is an abnormal cost of production; $DISEXP_{i,t}$ is manipulative expenses, equal to the sum of selling and administrative expenses; $A_DISEXP_{i,t}$ is abnormal discretionary expenses; $REV_{i,t}$ is operating income; $\Delta REV_{i,t}$ is the amount of change in operating income; $\Delta REV_{i,t-1}$ is the amount of change in operating income in the previous year; and $A_{i,t-1}$ is the value of total assets at the end of the previous period. Models (4), (5), and (6) are regressed by industry and by year, and the residuals of the regression are obtained and substituted into equation (7) to calculate REM.

3.2.2 Independent Variable

The level of fair value measurement (FVT) of listed companies is the independent variable of analysis in this research. Changes in the balance of non-recurring profit

and loss accounts are mainly affected by the non-primary business activities of enterprises, such as debt restructuring, non-monetary asset exchanges, and investment in financial instruments, etc. and the probability of the occurrence of this type of business is extremely low, so the use of non-recurring profit and loss items as a fair value measurement indicator has a large limitation [19].Therefore, in this research, the level of fair value measurement is assessed by calculating the ratio of the total fair value of assets and liabilities to the total asset value.

3.2.3 Control Variables

This article refers to the relevant literature [4-5][19], and selects a series of control variables, including company size, asset-liability ratio, board size, operating income growth rate, and whether it is audited by the big four. In addition, to avoid the influence of unobservable value, this paper also takes into account the industry and year fixed effects. See Table 1 for specific variable definitions.

Table 1. Variable names and definitions

Type	Name	Sign	Definition
Dependent variable	Degree of earnings management	<i>DA</i>	Degree of accrued earnings management
		<i>REM</i>	Degree of real earnings management
Independent variable	Fair value measurement level	<i>FVI</i>	The sum of assets and liabilities measured at fair value divided by the value of total assets
Control variable	Company size	<i>SIZE</i>	The log value of the total assets at the end of the current year
	Assets-liability ratio	<i>LEV</i>	Ratio of total liabilities to total assets
	Board size	<i>BOA</i> <i>RD</i>	Total number of board members
	Operating income growth rate	<i>INC</i> <i>OME</i>	The ratio of the increase in operating income to the previous year 's operating income
	Whether it is audited by the	<i>BIG</i> <i>4</i>	Virtual variables, whether the financial statements are audited by the four major

	Big Four		accounting firms.
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3.3 Empirical Model

In order to examine the influence of fair value measurement on corporate earnings management, this paper constructs benchmark regression models as equations (8) and (9).

$$DA_{i,t} = \alpha_0 + \beta_0 FVI_{i,t} + \beta_1 CONTROLS_{i,t} + INDUSTRY + YEAR + \varepsilon_{i,t} \tag{8}$$

$$REM_{i,t} = \alpha_0 + \beta_0 FVI_{i,t} + \beta_1 CONTROLS_{i,t} + INDUSTRY + YEAR + \varepsilon_{i,t} \tag{9}$$

where *DA* and *REM* are the dependent variables, *FVI* is the independent variable level of fair value measurement, *CONTROLS* is a series of control variables selected earlier, *INDUSTRY* and *YEAR* are the fixed effects of industry and year, and ε is a random disturbance term. This paper focuses on the regression coefficient β_0 .

4 Empirical Analysis

4.1 Descriptive Statistics

Table 2 presents the outcomes of descriptive statistics for the main variables. For the earnings management of listed companies, the average accruals-based earnings management (*DA*) is -0.0008 and the standard deviation is 0.0669. The mean of real earnings management (*REM*) is -0.0073 and the standard deviation is 0.1840; this manifests that the average degree of surplus management of listed companies is low, but there is a large difference between companies, with some engaging in both accrued earnings management and real earnings management. For the fair value measurement level (*FVI*) of listed companies, the mean is 0.2012 and the standard deviation is 0.1215; this indicates that there is also considerable diversity in the level of fair value measurement among listed companies.

Table 2. Descriptive statistics for variables

Variables	Mean	Standard	Minimum	Maximum
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		deviation		
<i>DA</i>	-0.0008	0.0669	-0.2365	0.2256
<i>REM</i>	-0.0073	0.1840	-0.7513	0.4997
<i>FVI</i>	0.2012	0.1215	0.0074	0.6187
<i>SIZE</i>	22.7272	1.2741	20.1448	26.6680
<i>LEV</i>	0.4557	0.1850	0.0773	0.8961
<i>BOARD</i>	7.8334	2.4096	0	14
<i>INCOME</i>	0.1080	0.2768	-0.5819	1.8241
<i>BIG4</i>	0.0766	0.2659	0	1

4.2 Empirical Results

The regression results in Table 3 demonstrate the impact of fair value measurements on corporate earnings management. In column (1), the analysis is focused on accrued earnings management, while column (2) concentrates on real earnings management. The findings indicate a noteworthy correlation between the degree of fair value measurement and corporate earnings management; for accrued earnings management (*DA*), the regression coefficient ($\beta=0.0488$) for the fair value measurement level (*FVI*) indicates a statistically significant positive relationship at the 1% level. For true surplus management (*REM*), the coefficient of regression ($\beta=0.0370$) for fair value measurement level (*FVI*) is remarkably positive at the 5% level. The above results support hypotheses H1 and H2, accordingly obtaining the core research conclusion of this paper: the degree of corporate accrued earnings management and the real earnings management will increase as the level of fair value measurement increases.

Table 3. Results of regression analysis of fair value measurement on corporate earnings management

Variables	<i>DA</i>	<i>REM</i>
	(1)	(2)
<i>FVI</i>	0.0488***	0.0370**

	(8.15)	(2.19)
<i>SIZE</i>	0.0071***	-0.0008
	(10.41)	(-0.42)
<i>LEV</i>	-0.0720***	0.2026***
	(-16.30)	(16.37)
<i>BOARD</i>	0.0007**	-0.0013
	(2.33)	(-1.49)
<i>INCOME</i>	0.0208***	0.0205***
	(7.83)	(2.76)
<i>BIG4</i>	-0.0069**	-0.0419***
	(-2.36)	(-5.06)
<i>Constant</i>	-0.1441***	-0.0552
	(-9.84)	(-1.34)
<i>INDUSTRY</i>	YES	YES
<i>YEAR</i>	YES	YES
N	8170	8170
Adj.R ²	0.0538	0.0417
F	59.00	45.45
Prob > F	0.0000	0.0000

Note: The statistical significance of the T-values is indicated by the values in parentheses, with *, **, and *** used to represent 10%, 5%, and 1% significance levels, respectively, similarly hereinafter.

5 Further Research Based on the Nature of Property Rights

Compared with non-SOEs, SOEs have less financing and cash flow pressures, while management tends to be subject to more scrutiny and has relatively less incentive to engage in profit manipulation [19]. State-owned companies need to consider profit growth and social benefits in an integrated way, which means they will be more cautious in the measurement model and earnings management. Therefore, it is of great importance to study the effect of the nature of property rights on corporate earnings management.

5.1 Split-Sample Descriptive Statistics Based on the Nature of Property Rights

Table 4 shows the descriptive statistics of samples classified by nature of ownership. The correlation between the degree of enterprise accrual earnings management (*DA*) and the nature of property rights is insignificant, while the level of real earnings management (*REM*) is affected by the nature of property rights. In addition, the average level of fair value measurement of non-state-listed companies is greater than that of state-listed companies.

Table 4. Results of descriptive statistics for the sub-sample of state-owned and non-state-owned firms

Property nature	Variab les	Mean	Standar d deviation	Minimu m	Maximu m
state-owned enterprises (SOEs) (N=3347)	<i>DA</i>	-0.000 6	0.0621	-0.2022	0.2287
	<i>REM</i>	0.039 0	0.1472	-0.4735	0.5179
	<i>FVI</i>	0.179 3	0.1202	0.0040	0.5976
Non-state-own ed enterprises (non-SOEs) (N=4823)	<i>DA</i>	-0.001 0	0.0704	-0.2575	0.2237
	<i>REM</i>	-0.015 5	0.2059	-0.8319	0.4749
	<i>FVI</i>	0.216 3	0.1203	0.0124	0.6245

5.2 Split-Sample Regression Analysis Based on the Nature of Property Rights

The results of the subsample regression analysis, which is based on the nature of property rights, are presented in Table 5. Columns (1) and (2) represent regression analyses conducted on state-owned enterprises, whereas columns (3) and (4) pertain to non-state-owned enterprises. The findings demonstrate significantly positive regression coefficients for fair value measurement levels across all variables. After

taking into account the concept of ownership, it is evident that the fair value measurement level continues to have a notable impact on the extent of corporate earnings manipulation, which further reinforces the main conclusions of this research.

Table 5. Results of regression for the sub-sample of different ownership

Property nature	state-owned enterprises (SOEs)		Non-state-owned enterprises (non-SOEs)	
	<i>DA</i>	<i>REM</i>	<i>DA</i>	<i>REM</i>
Variables	(1)	(2)	(3)	(4)
<i>FVI</i>	0.0576*** (6.53)	0.0476** (2.26)	0.0408*** (4.98)	0.0498** (2.00)
<i>SIZE</i>	0.0053*** (5.60)	-0.0095*** (-4.25)	0.0088*** (8.72)	-0.0036 (-1.17)
<i>LEV</i>	-0.0573*** (-9.31)	0.1579*** (10.75)	-0.0831*** (-13.32)	0.2229*** (11.79)
<i>BOARD</i>	-0.0004 (-0.93)	-0.0030*** (-2.97)	0.0015*** (3.23)	-0.0027** (-1.97)
<i>INCOME</i>	0.0041 (1.05)	0.0108 (1.13)	0.0349*** (9.83)	0.0361*** (3.37)
<i>BIG4</i>	-0.0119*** (-3.29)	-0.0211** (-2.43)	-0.0043 (-0.92)	-0.0616*** (-4.34)
<i>Constant</i>	-0.0975*** (-4.72)	0.2150*** (4.35)	-0.1823*** (-8.40)	-0.0105 (-0.16)
<i>INDUSTRY</i>	YES	YES	YES	YES
<i>YEAR</i>	YES	YES	YES	YES
N	3347	3347	4823	4823
Adj.R ²	0.0392	0.0441	0.0751	0.0385
F	18.05	20.29	50.01	25.14
Prob > F	0.0000	0.0000	0.0000	0.0000

6 Research Findings and Policy Recommendations

By utilizing data from Chinese A-share listed companies, this study analyzes how fair value measurement affects the level of corporate earnings manipulation. The research finds that the corporate fair value measurement level has a remarkable contribution on earnings management behavior; the core findings still hold through further research on the nature of property rights. Accordingly, this paper puts forward the following recommendations: First, the government needs to improve accounting standards and rules for fair value measurement and strengthen fair value disclosure requirements. Second, it should increase the supervision of corporate earnings management behavior to maintain the fairness, transparency, and sustainable development of the market.

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