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Corporate Strategy and Earnings Management

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Abstract: This paper mainly discusses the relationship between corporate strategy and earnings management by using multiple regression analysis. And the data of A-share listed companies in China from 2007 to 2016 are used. The result shows that the corporate strategy affects the level of earnings management and the choice of earnings management methods.

1. Introduction

Earnings management implies financial activities are adjusted or manipulated by the manager to maximize their own profit, including accrued earnings management and real earnings management. The manager mainly adjusts the accounting policies or the accounting estimate to realize the target profit, called accrued earnings management; and real earnings management is achieved by doing business. It is found that financing needs and financing constraints will lead the corporate to implement earnings management. That is to say, the managers tend to dressing the corporate performance to reduce the financing constraints and get more funds with lower financing costs [1]. In addition, both financing demand and financing constraints are deeply influenced by the corporate strategy. On the one hand, financing needs vary with the types of corporate strategy. For an instance, the corporate with aggressive strategy struggles for more funds to support market development, product development and capacity increases [2]. On the other hand, the aggressive corporate, usually placing itself at greater overall risk, will be subject to more financing constraints. Therefore, this paper holds that corporate strategy affects earnings management.

2. Literature Review and Hypothesis Development

The strategic deviance and the types of corporate strategy are discussed in this paper. The strategic deviance refers to the extent that the corporate strategy deviates from the conventional industry strategy. It is showed that corporate strategic deviance is significantly and negatively correlated with the value relevance of net income while positively related to the value relevance of owner's equity, which suggests that investors will consider the firm’s strategic information in stock pricing [3]. Then managers may manipulate earnings to reduce suspicions about their corporate strategy held by investors. Further, the more heavily the listed company strategy deviates from the industry conventional strategy, the more possibly the corporate earnings will be adjusted [4]. And compared with real earnings management, managers are more inclined to implement accrued earnings management [5]. It may be explained that the higher information asymmetry provides cover for those who want to dress the corporate performance. In particular, When the corporate strategy deviates from conventional industry strategy, it is more possible for the enterprise to have extreme performance value, which differs from the industry average level. And for smoothing the earnings, the operator tends to adjust the net profit. What’s more, the corporate with strategic deviance has different business model from others, which makes it more difficult for investors to make sound judgments just based on conventional criteria. This indicates that the strategic deviance will intensify the level of information asymmetry, and further facilitate surplus management.

According to the level of radicalism, there are three types of corporate strategy: radical strategy, analytical strategy and defensive strategy respectively. It is pointed out that the listed companies

with radical strategy in the U.S are more prone to financial irregularities than those with defensive strategy [6]; and compared to the defensive enterprises, radical enterprises take more aggressive tax avoidance to obtain higher retained profits, in order to support business growth and product development [7]. Moreover, for the aggressive enterprises focus more on expanding the market rather than the reputation maintenance, they are matched with relatively poor accounting conservatism influenced by higher business risk and heavier performance volatility [8].

Above all, the following hypothesis are put forward:

H1: the strategic deviance will aggravate the level of earnings management, and managers are more inclined to implement accrued earnings management than real earnings management.

H2: radical enterprises are more inclined to adjust earnings than defensive enterprises.

3. Variable Measurement and Research Design

3.1 Sample Selection and Data

The panel data of the A-share listed companies in China from 2007 to 2016 are selected in this paper. Considering the requirement of calculating variables, ST companies, financial and insurance companies and companies with missing data in the period are removed. Also, Winsorize on bilateral 1% digits is used to exclude abnormal value. The data are derived from CSMAR and are analyzed with STATA14.0.

3.2 Variable Measurement

Earnings management. The modified Jones model has been adopted to calculate the value (named a_1), and the value of accrued earnings management (AEM) is equal to the absolute value of a_1. Referring to Roychowdhury (2006), the anomalous operating cash flows (CFO), the anomalous production costs (PROD) and the anomalous discretionary expense (DISP) are calculated firstly. And then considering the possible internal offset, "|PROD|-|CFO|-|DISP|" is ultimately used to measure the value of real earnings management (EEM).

Corporate strategy (STRA). The strategic deviance index, created by Mintzberg (1978), is adopted to measure the value of strategic deviance ($STRA_1$). First of all, six indicators① are standardized in accordance with year and industry. And the six standardized indicators are changed into the absolute value and added up. Then the sum is computed into an average to measure the strategic deviance index. The dummy variables of the strategic type, proposed by Bentley (2013), are used to measure the strategic type ($STRA_2$). Firstly, five indexes② are divided into 5 groups in ascending order by year and industry, and then are assigned a value from 1to 4 in order. On the contrary, the index (fixed assets / total assets over the past five years) is divided into 5 groups in descending order by year and industry. And then the value of six indexes are added up. When the sum isn't less than 18, the corporate is defined as being aggressive (DEFEND) and assigned to 1; when the sum isn't more than 6, the enterprise is regarded as defense enterprise (PROS) and assigned to 1; others are assigned to 0 in one of two cases.

Control variables. The following indexes are selected: return on assets, asset liability ratio, the natural logarithm of total assets, operating income growth rate, corporate forms, CEO duality, board independence, and the dummy variables of industry and year.

3.3 Model Specification

In order to test the impact of corporate strategy on earnings management, the following regression model is constructed:

$$AEM / EEM = \alpha_0 + \alpha_1 STRA + \gamma CONTROLS + \varepsilon_{i,t} \quad (1)$$

① Six indicators are as follows: sales cost/ operating revenue, net intangible assets/ operating revenue, fixed assets/ number of employees, net fixed assets/ fixed assets, administration costs/ operating revenue and financial leverage respectively.

② Five indexes are as follows: intangible assets / operating revenue, the number of employees / operating revenue, operating revenue growth rate, (sales costs + administration costs) / operating revenue, the standard deviation of number of employees in the past five years / average number of employees in the past five years.

4. Results

In the point of strategic deviance, the regression results of strategic deviance (STRA1) and accrued earnings management (AEM) and real earnings management (EEM) are showed in the column of (1) and (2) in the table 1 respectively. From the (1) column, the coefficient of STRA1 and AEM is 0.0115, and it is significantly positive at 1% level. It is implied that the level of accrued earnings management is stronger with heavier strategic deviance. It can be explained that strategic deviance increases the extent of information asymmetry between the operators and external stakeholders, which enhances the invisibility of earnings management. From the (2) column, it is turned out that the STRA1 is negatively correlated with real earnings management (EEM) (the coefficient is -0.0359 and P value is less than 1%), indicating that heavier strategic deviance will inhibit the occurrence of real earnings management. It may be clarified that the inappropriate real deal will be largely harmful to the corporate long-term performance when implementing real earnings management [9]. However, financial data are adjusted in accrued earnings management and it won't do much damage to the enterprise long-term profit. Above all, it is found that strategic deviance will improve the level of accrued earnings management and inhibit the level of real earnings management. And the hypothesis H1 is supported.

Table1 The regression results between corporate strategy and earnings management

Variable	AEM		EEM		AEM		EEM	
	(1)		（2）		(3)		（4）	
STRA1	0.0115***	6.55	-0.0359***	-5.51				
DEFEND					0.0031	1.51	-0.1176***	-15.34
PROS					0.0049**	2.37	-0.0006	-0.08
LNA	-0.0031***	-5.15	0.0029	1.27	-0.0033***	-5.38	0.0076***	3.39
LEV	0.0271***	6.63	-0.0236	-1.55	0.0283***	6.92	-0.0305**	-2.02
ROA	0.0987***	6.91	0.3447***	6.48	0.094***	6.55	0.2899***	5.48
YZ	0.0135***	9.59	-0.0623***	-11.87	0.0139***	9.66	-0.0721***	-13.64
LH	0.0024	1.44	0.007	1.12	0.0025	1.49	0.0044	0.7
DD	0.0323***	2.8	0.0443	1.03	0.0324***	2.8	0.0312	0.73
SOE	0.0007	0.58	-0.0106**	-2.34	0.0006	0.51	-0.0096**	-2.13
MS	0	-0.15	0.0009	4.05	0	-0.63	0.0008***	3.59
C	0.092***	6.75	-0.1315**	-2.59	0.1031***	7.57	-0.2398***	-4.77
YEAR	control		control		control		control	
INDUSTRY	control		control		control		control	
F	39.98		50.32		37.71		55.58	
A-R^2	0.0984		0.1213		0.0957		0.1359	
N	12,147		12,147		12,147		12,147	

Note: the significant levels of 1%, 5% and 10% are represented by "* * *", "* *"and "*" respectively; the coefficient is listed in the left side of each column, and the corresponding T statistic in the right side.

The regression results between corporate strategic types (DEFEND, PROS) and earnings management methods are listed in the column of (3) and (4) in the table 1. According to the (3) column, it is suggested that PROS is positively correlated with the accrued earnings management at the 5% level while DEFEND isn't. It shows that, compared to the defense corporate, the aggressive is more likely to implement accrued earnings management. Generally, the radical enterprise performance is more volatile. And considering the trust of external stakeholders, it has more incentives to confirm "favorable information" as soon as possible and delay the confirmation of "bad news". From the (4) column, it shows that DEFEND is significantly negatively related with real earnings management while PROS isn't. And it indicates that it isn't more possible for the defense enterprises to implement real earnings management than radical enterprises. On the whole, the radical enterprises have stronger incentive to manage the earning, and the hypothesis H2 is verified.

5. Conclusion

Based on the data of A shares listed companies in 2007~2016, the relationship between corporate strategy and earnings management was empirically studied in this paper. The results show that: on the one hand, strategic deviance will improve the level of accrued earnings management and inhibit the level of real earnings management; on the other hand, the radical enterprises have stronger incentive to manage the earning. We hope this paper will further enrich the research between strategic theory and earnings management, and attract investors' attention to strategic information for their investment decisions.

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