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A Research on the Relationship between Accrual-based Earnings Management and Real Earnings Management in the Retail Industry

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Abstract

Purpose - In this paper, we examine the effect of accrual earnings management and real earnings management on the corporate value of retail corporations. **Research design, data, and Methodology** - The sample cover firms whose settlement is December among retail companies listed on the Korea Stock Exchange's securities market and KOSDAQ market from 2001 to 2016. Of these, the targets were companies with operating profit and equity capital of zero or higher and with sales data. The secondary data was collected through KIS-VALUE data base. The Jones model and the modified Jones model were used for the calculating the accrual-based earnings management and the real earnings management. **Result** - According to the empirical results, the relationship between accrual earnings management, real earnings management and firm value is positively significant in the retail industry as in manufacturing industry. These results are also significant when controlling the size, profitability, investment, debt ratio, dividend, and growth potential of a company. **Conclusions** - The characteristics of the distribution business can be identified and the influence of the various kinds of earnings management, which is being researched around the manufacturing industry, can be studied in the distribution industry to give practical implications to investors..

Keywords: **:** Jones Model, Modified Jones Model, Accrual-based Earnings Management, Real Earnings Management, Firm Value

JEL Classification Code: D30, G30, G32

1. Introduction

Corporate inner stakeholders, for example the executives and majority shareholders, have an incentive to adjust their profits for their own benefit. In the past, corporates' accounting management have adjusted their profits by selecting an accrual-based earnings management. In other words, profit has been adjusted by selecting an advantageous method of accounting, which creates an information asymmetry problem, thereby hindering efficient allocation of resources (Choi & Kim, 2013). However, there has been a steady rise in the reliability and usefulness of the accounting information that such an accrual-based earnings management brings. Legal issues have been raised as a result of the accrual-based earnings management and a case is revealed in Daewoo Shipbuilding & Marine Engineering Co.'s accounting manipulation case.

The police investigation began in 2015 with a probe into alleged embezzlement by a former employee.

The police investigation revealed in June 2016 that there had been 5.4 trillion won in fraudulent accounting for three years from 2012 to 2014. Based on such adjusted financial statements, Daewoo Shipbuilding & Marine Engineering gave performance bonuses to its executives and employees. Investors took a heavy loss from their investments in the financial statements. As of October 2017, about 7.1 trillion won of public funds were injected, and accountants in charge of external accounting audits arrested in court and were sentenced to prison and the corresponding accounting firm paid a large fine and went bankrupt. Rahman, Meah, & Chaudhory (2019) recommended that the regulatory authority and audit committee should review the frequencies of audit committee meeting to make it more

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effective to ensure better firm performance. Earnings quality positively affects financial analysts' dividend forecasts (Nam, 2019). And Corporate governance practices affect the firm performance(Muhammad, Rehman, & Wagas (2016).

As a result, the various checks on the accrual-based earnings management have been strengthened due to the awareness of stakeholders who have recognized the problem with the accrual-based earnings management, resulting in the change of the entity's earnings management method to real-earnings management, which adjusts profits through real economic activities. The earnings management method using real activities is known as a way that is unrelated to future cash flows because it adjusts profits by adjusting the firm's operating and investment decisions, whereas the earnings management method through accruals utilizes accounting choices (Kang & Chun, 2010).

If the capital market is efficient, it should be easy for inner and outside stakeholders to identify distorted information, such as earnings management, that results in conveying distorted information to the market for the purpose of private gain. Baygi, S., & Javadi, P. (2015) showed that timeliness of information has positive effect on the creation of economic value added. Ryu (2019) found that there was a significant positive association between unfaithful disclosure corporation designation and stock price crash.

However it is still not easy for many companies to recognize this correctly and reflect it in their decision making (Choi & Kim, 2013). The real earnings among earnings management method are difficult for external stakeholders to observe and are likely to be used by management as a means to adjust profits opportunistically. Also, compared to the accrual-based alignment management, which is likely to be detected by outside monitoring, it is more difficult for outside stakeholders to know about the real-earnings arrangement (Kim, 2009; Choi & Kim, 2013). Earnings management through accruals may seem to worsen in the short term due to the reverse effect of the accruals, and the earnings management through the past accruals may be difficult for the current term (Lee et al., 2017). On the other hand, real earnings management adjusts profits through decisions about the actual management activities and cash flows of the firm, resulting in inefficient allocation of resources, which negatively affects the long-term performance of the firm, such as research and development (Lee et al., 2017).

The distribution industry is like the blood vessel of the national economy, which plays a role in promoting consumer welfare and raising and maintaining the competitive edge of manufacturing among producers and consumers. However, there is a perception that the distribution industry is relatively less competitive than the manufacturing industry where capital-intensive investments are made. The recent streamlining of the distribution industry and the smooth flow of goods, funds and knowledge through innovation can be an important foundation for the nation's economic development, while Lotte Group and Shinsegae Group have also shown an edge in competition with global distribution companies. The role of these differentiated Korean retail companies is enough to attract the attention of many investors, such as institutional or foreign investors.

This study attempts to analyze the relationship between accrual-based earnings management and real earnings management for retailers listed on the Korea Stock Exchange's securities and KOSDAQ markets from 2001 to 2016. The differentiation from prior research is as follows. Compared to previous studies covering real earnings management for manufacturing companies, this study is for distribution companies that have been performed relatively little research. It can be said that due to the nature of the distribution business, the real earnings management probability in distribution industry is not lower than that of the manufacturing company, and that it is a good attempt to identify the changes in the distribution business that have seen a recent increase in the proportion of capital investment in relatively labor-intensive features.

The rest of the study is carried out as follows. Chapter 2 looks at the preceding studies of real earnings management. Chapter 3 deals with research samples and analysis methodology. Chapter 4 describes the results of the empirical analysis and Chapter 5 presents conclusions and implications.

2. Literature Review

Dan and Tran (2019) confirmed an abnormal existence of accrual in the Vietnam stock market. Their results showed that aggregate accrual is negatively correlated with future operating profit and future stock return.

Kim (2009) verified accrual-based earnings management using the KOSPI and KOSDAQ listed companies and found that KOSDAQ listed companies have significantly higher discretionary value and larger and lower quality of accounting profit than those of the KOSPI listed companies. In addition, it is analyzed that the share price relevance of the accounting profit of KOSDAQ-listed firms is low, which can be seen as investors' negative assessment of the accounting profit of KOSDAQ-listed firms compared to the accounting profit of the KOSPI-listed firms.

Park, Park, and Park (2012) performed an analysis of unlisted companies using corporate credit data on the impact of the adjustment of corporate profits on corporate earnings. The analysis results showed that the higher the level of discretionary accruals and real earnings management for both listed and unlisted firms, the more significantly downward the firms' credit ratings.

Kim (2015) analyzed what costs in terms of accrual and real earnings management affected the management's choice of an earnings management method. The analysis using samples from firms having high earnings management probability found that the real earnings management is constrained by market share within the industry, financial soundness, and whether a company belong to a chaebol. In Korea, resource-rich chaebols preferred real earnings management over accrual-based earnings management, the institutional ratio did not affect the earnings management activity, and the continuous audit period of the same accounting firm did not affect the accurate-based earnings management. In addition, Kim (2015) demonstrated that managers decide on the size of the arrangement based on the relative cost of the two methods, based on the empirical analysis of which of the two methods they prefer.

Kim (2015) showed that companies with less competitive status in the industry, non-chaebol companies, and companies with more control from financial malaise used more accrual-based earnings management and less real earnings management. However, if the shorter operating cycle constrains the firm's accounting methods, the opposite would be true.

Lee et al. (2017) studied the relationship between the joint management structure and real earnings management as one of the governance methods to monitor and control profit-seeking behaviors that are opportunistic to management. As a result of the analysis, it was found that the degree of real earnings management has decreased in the joint management structure, and that the relationship between the joint management structure and the real earnings management has weakened in the chaebol companies that have various opportunities to induce earnings management. Thus, it was found that the role of sound governance performed by the joint management structure is affected by the circumstances surrounding it.

Bae and Kim (2013) studied whether there were any differences in real earnings management depending on the business life cycle. In the growth stage, companies were primarily trying to lower their real earnings management, which negatively affected their performance in the following year. In the declining stage, companies sought to increase their real earnings management, which had a positive impact on their performance in the following year. In addition, the capital market recognized only the upward earnings management of companies in the declining stage and reflected it in value evaluation, which resulted in a drop of share price return in the following year.

Choi and Kim (2013) looked at whether the capital market by itself can curb earnings management by investors who efficiently evaluate on the decrease in the accrual-based earnings management and the increase in the real earnings management. The analysis found that investors did not have sufficiently assess real earnings management because investors tend to relatively overestimate large scale real earnings management. It also said investors used foreign ownership as a base for valuations in real earnings management that is relatively difficult to detect. General investors have shown excessive faith in the negative relationship between foreign investors and real earnings management. When the foreign ownership is high, it tends to overestimate profitability. These results showed that in a firm where foreign ownership is relatively high, caution is needed in valuation.

Choi and Kim (2013) analyzed that the reason for the real earnings management is because management has more benefits to satisfy their personal records, even if their performance is expected to deteriorate. In addition, market penalties were not significant for real earnings arrangements, which are inherently difficult for external investors to detect.

Kim (2014) analyzed how CSR affects both the earnings management and the firm value. The results showed that the KEJI index and earnings management have negative relationship, and that the more the corporate social responsibility activities, the more accounting transparency. In addition, the higher the KEJI index leads to the larger the earnings per share. A high level of accounting transparency increases the credibility of external investors and disclosed accounting information is reflected relatively significantly in the firm value. The market gave a positive assessment of companies with active CSR.

Kim, Yu, and Kim (2012) found that real earnings management increases not only the cost of equity but also the cost of debt, even after controlling accrual-based earnings management, systematic risk of a firm and market-to-book value ratio which are corporate-specific risk. Among the measures in the real earnings management, it was found that the unusual operating cash flows increased the capital expense relatively larger than the abnormal production cost or the abnormal discretionary expenses. These results show real earnings management as well as opportunistic accrual-based earnings management brings high cost of capital by increasing information asymmetry for corporate' performance between managers and outside investors.

Park, Park, and Shin (2012) analyzed non-financial firms listed on the securities market from November 2002 to December 2009, when the fair disclosure system was introduced, that published their forecasts for their business performance through fair disclosure system. The empirical analysis shows that the more accruals generated the firm, the less accurate the management's profit prediction is. Rather than managers using the accruals to increase the accuracy of the profit prediction, the management could confirm that there is a possibility of a common prediction error between the profit forecast and the amount generated by the entity's uncertainty. Therefore, an entity's uncertainty exists, which is likely to result in a common forecast error between the profit estimate and the amount of accruals. In addition, using volatility of stock price, operating cash flows, and sales growth, the results showed that the higher the amount of uncertainty, the lower the accuracy of profit prediction. This means that errors in future profits predicted by management are reflected in the amount of accruals, as the uncertainty is relatively large, making future profit forecasts difficult for companies. So, personal abilities and characteristics of the management have a common effect on the firm's overall management activities, such as voluntary and mandatory disclosures.

Park (2012) found that auditing firms that formed strategic alliances with foreign companies decreased not only the amount of accrual-based earnings management but also the amount of real orders management. Audit time controls the accrual-based earnings management, but there was no influence on the real earnings management. In addition, even if the costs of accrual-based earnings management increase, the amount of real earnings management does not increase dramatically, and the management used two methods complementarily.

Studies of the earnings management that have been done so far have been mainly centered on manufacturing. Rahman & Hasan (2019) observed that profitability of cement sector which is much volatile and prone to be manipulated in Bangladesh.Unlike manufacturing, which requires continuous investment in R&D and development of new products, the distribution industry plays a role in connecting products produced with consumers (Ryu & Yook, 2013). Ryu and Yook (2013) studied the association with the firm value of intangible assets in the distribution industry, compared to manufacturing, where investment in intangible assets plays an important role in determining the survival of a company. Studies have shown that the more intangible assets held in the distribution industry, the lower the net book value is reflected in the firm value, but the more intangible assets held, the lower the level of accounting profit is reflected in the firm value. This confirmed that intangible assets have different meanings in the distribution and manufacturing industries.

In relation to a firm's earnings management, the main methods that a company can adopt can be divided into two categories, the accrual-based earnings management and the real earnings management, with each characteristic being used by managers as an earnings management tool. Academic research has been conducted mainly on manufacturing of these alternative management tools. However, in the case of distribution businesses, no research has been conducted on these means. In the case of distribution businesses, an in-depth study of the role of these two alternative management measures is needed, so this study examined the effect of the accrual-based earnings management and real earnings management on the value for the distribution industry.

3. Sample and Methodology

The sample cover firms whose settlement is December among retail companies listed on the Korea Stock Exchange's securities market and KOSDAQ market from 2001 to 2016. Of these, the targets were companies with operating profit and equity capital of zero or higher and with sales data. The financial data was collected through KIS-VALUE.

The accrual-based earnings management used the Jones model (Kim, 2015; Shirzad, Mohammadi, & Haghighi, 2015) and the modified Jones model (Kim, 2014; Park et al., 2012; Park, 2012), and the real earnings management used the of Roychowdhury (2006). In many studies, discretionary accruals are used as an earnings management proxy (Paek, 2000; Kim, 2015). The discretionary accrual is measured as the difference between the actual occurrence and the normal level of a firm(Kim, 2015).

It is reported that the discretionary accruals, measured in the Jones model and the modified Jones model, best captures the alignment of the models presented as a measure of the discretionary accruals (Paek, 2000). Paek (2000) was developed and presented with the revised Jones model from the Jones model and the modified Jones model, which includes only sales and property, plant and equipment. As a measure of real earnings management, the measure used by Roychowdhury (2006), Kim and Lee (2012) were used as real earnings management as unusual operating cash flows, abnormal sales and general management costs, and abnormal manufacturing costs. For the sake of the analytical convenience, it can be interpreted that the positive dependent variables represent an upward revision of profits, while the negative dependent variables mean a downward revision of profits, and the greater the absolute values, the higher the degree of profit adjustment, by using the values multiplied by –1 when the dependencies are the abnormal operating cash flows and the abnormal sales and management costs.

Table 1: Description of Variables

variables		descriptions
dependent variable	MB	(market value of common shares and preferred shares+book value of debt) /book value of total asset
independent variable	AbCFO×(-1)	Abnormal Operating Cash Flows (equation 5)×(-1)
	AbSGA×(-1)	Abnormal Selling Costs and Administrative Costs(equation 6)×(-1)
	AbPRD	Abnormal Production Costs(equation 7)
	MJones	Modified Jones Model
	AMJones	Performance Modified Jones Model
control variable	Roa	Net Income/Total Asset(t-1)
	Inv	(Tangible Assets(t)-Tangible Assets (t-1))/Tangible Assets(t-1)
	Debt	Total Debt/Total Asset
	Size	ln(Total Asset)
	Div	Cash Dividends/Net Income
	Grw	(Sales(t)-Sales(t-1))/Sales(t-1)
	Beta	Beta

For the control variables, the variables related to a firm's earnings management were selected by referring to the preceding studies. Variables are winsorized at the top and bottom 1% in order to eliminate the effects of extreme values during the empirical analysis. <Table 1> provides definitions of the main variables in this study.

4. Empirical Results

4.1. Summary Statistics and Correlations

Table 2 is a summary statistic for the major variables. The average (standard deviation) of the actual operating cash flows (-1×AbCFO) estimated is 0.020 (0.135), the mean (standard deviation) of the abnormal sales and management costs (-1×AbSGA) is 0.001 (0.257), the mean (center value) of the abnormal manufacturing costs (AbPRD); on average, sample companies adjust their profits through real operating activity. In the previous studies related to earnings management, Choi and Kim (2013) showed average abnormal operating cashflow, abnormal manufacturing costs, abnormal accrual are 0.006, 0.005, -0.000 respectively, and Park et al. (2012) showed average accruals from modified Jones models 0.0052, mean 0.0035. In research of Park (2013), average estimated real earnings management showed negative(-) values, and this shows that estimates of real earnings management can be varied depending on the research period. From the mean and standard deviation of earnings management estimates, the sample used in this study includes firms that revise profits upward or downward.

The samples used in Kim (2014)'s study were blue-chip companies whose KEJI was announced, with the average asset size (SIZE) and debt ratio (LEV) at 27.017 and 0.386, respectively, and the median value of 26.732 and 0.370, respectively. The average corporate size (SIZE) in Kim, Yu, and Kim (2012) was 25.24 (median: 24.90), BETA 0.8625 (median: 0.8510), market value to book value (MB) was 0.8488 (median: 0.6372), and debt ratio (LEV) was 0.45 (median: 0.45). The average corporate size of the sample of this study is 25.62, the average of beta 0.75, and the average debt ratio is 0.44, similar to the characteristics of the sample of Kim et al. (2012).

The correlation coefficient between the major variables is given in Table 3. Company size has a negative relationship and book-to-market has a positive relationship with the two earnings management. Debt ratio and ROA has negative and real earnings management has positive relationship with accrual-based earnings management. As the correlation between the explanatory variables appears to be significant, the value of variance expansion factors (VIF) was obtained for each variable to diagnose the possibility of multicollinearity during the cross-sectional analysis.

Table 2: Descriptive statistics

	Count	Mean	Median	Stdev	Min	Max
MB	1248	1.178	0.993	0.674	0.439	4.895
AbCFO ×(-1)	1388	-0.02	-0.019	0.135	-0.617	1.679
AbSGA ×(-1)	1430	0.001	0.075	0.257	-1.172	0.942
AbPRD	1313	-0.006	0.014	0.289	-1.689	4.250
MJones	1372	0.017	0.012	0.175	-1.722	2.119
AMJones	1372	0.029	0.023	0.179	-1.730	2.128
Roa	1528	0.046	0.039	0.085	-0.627	0.320
Inv	1427	0.337	0.002	1.587	-0.873	12.546
Debt	1528	0.442	0.437	0.195	0.065	0.898
Size	1528	25.671	25.411	1.743	21.843	29.943
Div	857	0.295	0.180	0.507	-0.860	3.485
Grw	1430	0.195	0.079	0.563	-0.554	3.904
Beta	1246	0.746	0.74	0.456	-0.59	3.64

* Variables was winsorized at ±1%.

The value of the VIF was between 1.2 and 2.2, and it was found that there was no need to be concerned about multicollinearity.

Table 3: Correlation Analysis

	MB	AbCFO×(-1)	AbSGA×(-1)	AbPRD	M Jones	AM Jones	Roa	Inv	Debt	Size	Div	Grw	Beta
MB	1												
AbCFO×(-1)	-0.019	1											
AbSGA×(-1)	-0.200*	0.068*	1										
Ab PRD	-0.123*	0.373*	0.470*	1									
M Jones	-0.035	0.601*	0.064*	0.174*	1								
AM Jones	-0.051	0.601*	0.087*	0.168*	0.977*	1							
Roa	-0.0122	-.238*	-0.173*	-0.195*	0.295*	0.276*	1						
Inv	0.084*	0.018	-0.012	0.024	0.041	0.033	0.034	1					
Debt	-0.037	0.109*	-0.079*	0.096*	-0.058*	-0.055*	-0.085*	0.0114	1				
Size	-0.0483	-0.011	-0.013	0.140*	-0.074*	-0.078*	-0.078*	-0.133*	0.246*	1			
Div	-0.008	0.037	-0.004	0.011	0.005	-0.003	-0.118*	-0.007	-0.021	-0.142*	1		
Grw	0.177*	0.020	-0.182*	0.0216	-0.090*	-0.102*	0.067*	0.150*	0.039	-0.178*	-0.019	1	
Beta	0.183*	0.006	0.043	0.019	-0.027	0.002	-0.044	-0.017	0.023	0.021	0.005	0.012	1

*Significant at 5%

4.2. Regression results

<Table 4> summarizes the results of the regression analysis to look at the effect of the earings management on the firm value.

Model (1) us the results of a regression analysis that includes only the control variables, and models (2) through (4) present the results of measuring the real earnings management, which are the dependent variables, measured from the abnormal operating cash flows, abnormal sales and general management costs, and abnormal manufacturing costs. Models (5) and (6) show the results in the Jones model and the modified Jones model.

The empirical analysis revealed significant negative effects in both the relationship between accrual-based earnings management, real-earnings management and firm value in the distribution industry. These results showed that the distribution industry has a negative relationship with the firm value in the case of earnings management, as in the manufacturing industry.

In <Table 4> the relationship between the control variables and firm value is as follows. This study showed a partially significant negative (-) relationship between the size of a firm and the firm value, and a significant positive (+) relationship between profitability and the firm value. This is in line with the results of Kim (2009), Park (2012), Lee et al. (2017). Second, a significant positive (+) relationship between the debt ratio and the firm value was showed. This is in line with the results of Ruonan & Hong (2019) who found that corporations disclosing more and higher quality CSRD are often those faced with financing constraints. They concluded that voluntary disclosure can help firms alleviate information asymmetry and financing constraints.

Table 4: Test of the Relationship between Earnings Management and Firm Value

Model	(1)	(2)	(3)	(4)	(5)	(6)
Dep.	MB					
AbCFO×(-1)		-0.678**				
		(-2.418)				
AbSGA×(-1)			-1.345***			
			(-7.353)			
AbPRD				-0.747***		
				(-5.052)		
MJones					-0.662**	
					(-2.070)	
AMJones						-0.711**
						(-2.368)
Roa	3.600***	3.248***	2.763***	2.955***	4.053***	4.078***
	(4.138)	(3.837)	(3.613)	(3.683)	(4.971)	(4.997)
Inv	0.047	0.048	0.057*	0.047	0.049	0.050
	(1.388)	(1.460)	(1.771)	(1.330)	(1.492)	(1.506)
Debt	0.316*	0.375**	0.064	0.275*	0.346**	0.344**
	(1.913)	(2.266)	(0.426)	(1.721)	(2.139)	(2.134)
Size	-0.007	-0.009	0.051***	0.029*	-0.012	-0.010
	(-0.458)	(-0.586)	(3.208)	(1.751)	(-0.770)	(-0.690)
Div	0.042	0.043	0.037	0.053	0.045	0.043
	(0.750)	(0.738)	(0.760)	(0.938)	(0.793)	(0.750)
Grw	0.366**	0.393***	0.278**	0.528***	0.347***	0.341***
	(2.549)	(2.638)	(2.110)	(3.172)	(2.734)	(2.749)
Beta	0.161***	0.159***	0.184***	0.195***	0.159***	0.161***
	(3.200)	(3.106)	(3.762)	(3.840)	(3.102)	(3.163)
constant	0.624*	0.634	-0.431	-0.389	0.702*	0.654
	(1.791)	(1.515)	(-1.117)	(-0.860)	(1.688)	(1.577)
year dummy	included	included	included	included	included	included
industry dummy	included	included	included	included	included	included
observation	733	731	733	698	731	731
R-squared	0.206	0.215	0.313	0.264	0.216	0.218

Third, the relationship between the growth variable (Grw) and the firm value was shown significant positive relationship (+).

5. Conclusion

Existing studies mainly look at the relationship between earnings management and firm value mainly focusing on manufacturing. In terms of managerial private benefit and corporate governance of managers, interest in the areas of earnings management has continued. However, little research has been done on the role of earnings management in the distribution industry. Identifying the characteristics of the distribution industry and looking for differentiation or similarity from other industries may expand the scope of interest in earnings management. The results of this empirical analysis show that, firstly, in the distribution industry, as in manufacturing, the accrual-based earnings management and real earnings management have a significant negative effect on the firm value. Through this, it was understood that there was a need to protect investors and enhance transparency in the related areas by identifying the actions of earnings management in the distribution industry. Secondly, the firm value was high for companies with significant growth in sales and profitability.

Based on this study, the characteristics of the distribution business can be identified and the influence of the various kinds of earnings management, which is being researched around the manufacturing industry, can be studied in the distribution industry to give practical implications to investors. However, the study failed to include a variety of factors, including corporate governance factors, in its early mornings management

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