Abstract

This is an opinion study of earnings management in mainland China. We review the related literature and define earnings management as a continuum of purposeful intervention from legitimate accounting choices to fraud that violates General Accepted Accounting Principles (GAAP). We present a theoretical framework to understand earnings management in mainland China, and send questionnaires to managers and accountants in Chinese companies. The result from the questionnaires shows that earnings management consideration and behavior is related to the market environment and institutional settings. Size and ownership of the companies will influence the earnings management incentives and techniques in China in a material way. Public ownership companies have stronger incentive to manage earnings for management compensation, while private ownership companies pay more attention to tax expense saving. Several techniques are popular in China, such as using related party transactions, manipulating operational revenue and accounts receivable and allowance for bad debt. The pervasiveness of earnings management in China results from the institutional arrangement in the Chinese market, and the improvement of earnings data quality can only be achieved by full-scale and deep market reform.