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Real Earnings Management and Accrual-based Earnings Management

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Abstract. Against the backdrop of the rapid development of the capital market and increasingly fierce corporate competition, earnings engagement, working as an important means for enterprises to adjust financial information, has attracted much attention regarding its rationality and potential risks. Enterprises influence financial statements through earnings management to achieve certain effects, which may mislead investors' decisions and disrupt the efficiency of resource allocation in the capital market. Therefore, in-depth research on it is of great practical significance. This study focuses on real earnings management and accrual-based earnings management in corporate financial management. By comparing and analyzing their operational mechanisms, specific measures, differential characteristics, and industry application scenarios, it aims to reveal the motives, means, and governance paths of earnings management. The study finds that real earnings management adjusts earnings through constructing real transactions, such as production manipulation and related party transactions, which directly affect corporate cash flows and business activities. While accrual-based earnings management adjusts profits by virtue of accounting policy choices, which act more on financial statement data. These two types of earnings management show differentiated characteristics and applications in the manufacturing industry and service industry. In view of their respective disadvantages, this paper puts forward adjustment measures such as improving accounting standards, strengthening internal governance, and enhancing audit quality, so as to provide references for enterprises to standardize financial operations and optimize regulatory policies.

Keywords: Earnings Management, Real Earnings Management, Accrual-based Earnings Management

1. Introduction

With the continuous development of corporate financial management practices, earnings management, as a key issue affecting the quality of financial information, has always been the focus of academic attention. Existing studies have conducted in-depth discussions on real earnings management and accrual-based earnings management, confirming that the former adjusts profits through actual business activities, while the latter adjusts financial statement data relying on accounting policy choices and changes in accounting estimates. However, there are still obvious deficiencies in current research: first, most existing literature analyzes the two types of earnings

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management methods in isolation, lacking comparisons of their application differences; second, they have not fully revealed enterprises' preference for earnings management methods under the operating characteristics of different fields; third, there is a lack of research on integrated governance adjustment plans for the disadvantages of the two types of earnings management. In view of this, this study takes the comparison of different industries as the starting point, and deeply analyzes the specific measures, application motives and potential consequences of real earnings management and accrual-based earnings management in different industries. This research aims to answer the following questions: ① the specific measures of the two types of earnings management methods; ② the differences in the application of the two types of earnings management methods in different industries; ③ the disadvantages and adjustment plans of the two types of earnings management methods.

In terms of research value, theoretically, through systematic comparison of the two types of earning management, this study can make up for the deficiency of insufficient attention to their application differences in existing research. Combining industry characteristics to analyze selection preferences can enrich the theoretical system in this field and provide a new perspective for subsequent research. In practice, after clarifying the measures and problems of the two types of earning management, the proposed governance plans can provide guidance for enterprises to standardize their financial behaviors and improve information quality, and also serve as a reference for regulatory authorities to formulate targeted policies and optimize the regulatory environment, helping to maintain the fairness and efficiency of the capital market and protect the rights and interests of investors.

2. Earnings management

2.1. Motives for earnings management

The motives for earnings management are diverse and complex, influenced by various internal and external factors of enterprises. These motives drive corporate management to implement different earnings management mechanisms. Especially driven by factors such as taxation and debt, management may seek to boost short-term financial profits [1] to achieve various goals, such as meeting performance evaluation requirements, attracting investors' attention, and improving corporate economic efficiency.

2.1.1. Pressure from performance commitments

In the context of corporate restructuring, mergers and acquisitions, some management teams face conditions such as being bound by clear performance indicators. If the actual operating results deviate from the committed targets, it will give rise to a strong motive for earnings management. This motive arises from irresistible consequences of breaching performance commitments, such as high default costs and invisible losses to reputation. Performance contracts usually stipulate that if the target company fails to meet the committed performance, the original shareholders must fulfill compensation obligations, and the management may face professional risks such as bonus deductions and dismissal. Meanwhile, the acquirer may send a new management team, leading the original management to lose operational control. Under such dual pressures of income and reputation, enterprises have developed various earnings management measures to alleviate the pressure from performance commitments [2].

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2.1.2. Tax burden

When the statutory tax rate is high or tax collection and management become stricter, management tends to adjust tax costs to change taxable amounts through accounting policy choices or the construction of real transactions. This tax avoidance method is usually a major driving force for enterprises to engage in earnings management. Enterprises may reduce expenses by delaying employee benefits and cutting public welfare expenditures [1] to lower tax burdens. However, such practices will not only affect employees' work enthusiasm but also weaken the enterprise's reputation and social responsibility, thereby causing certain negative impacts on the enterprise.

2.2. Real earnings management

As a component of earnings management, real earnings management typically manipulates a company's earnings level by constructing real economic activities. Unlike accrual-based earnings management, this approach does not rely on accounting methods but instead influences financial statements through actual operational decisions and transactions. It directly impacts core business processes such as production, sales, and expenses [3].

With the development of capital markets and increasingly stringent regulatory environments, the scope for accrual-based earnings management has become more restricted. As accounting standards continue to improve and regulatory bodies raise requirements for the quality of accounting information, it has become more challenging for enterprises to manipulate earnings through accounting policy choices or changes in accounting estimates. Following the Enron scandal, the U.S. enacted the Sarbanes-Oxley Act, strengthening oversight of financial reporting by listed companies and imposing stricter constraints on accrual-based earnings management. Under the combined effects of intensified market competition and the growing complexity of business operations, real earnings management has shown a continuous upward trend.

2.3. Accrual-based earnings management

Accrual-based earnings management refers to the practice where corporate management controls or adjusts the accounting earnings information reported externally by leveraging accounting policy choices and changes in accounting estimates within the framework of accounting standards. This is done to achieve specific financial objectives or meet the expectations of stakeholders. Unlike real earnings management, which manipulates earnings through actual business activities, accrual-based earnings management primarily operates at the accounting processing level. Companies can select favorable methods in various activities, such as depreciation calculations and bad debt provisions to achieve their earnings management goals. The existence of accrual-based earnings management stems from the flexibility inherent in accounting standards, which grant enterprises a certain degree of discretion in selecting accounting policies and making estimates to accommodate diverse business characteristics and operational needs.

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3. Specific measures of real earnings management and accrual-based earnings management

3.1. Measures of real earnings management

3.1.1. Regulation of production and business activities

Enterprises manipulate earnings by adjusting production costs, sales policies, and other operational factors. In terms of production manipulation, overproduction is a common tactic. By producing significantly more than market demand, companies can reduce the per-unit production cost [3]. While this strategy may improve short-term financial metrics by spreading fixed costs under the full costing method, it often leads to inventory pile-ups and subsequent price-cutting risks. For example, an automaker inflated production by 40% to boost performance, reducing unit costs by 15%. However, it had to recognize a $230 million inventory impairment the following year due to excess stock [4]. In sales strategies, companies often offer abnormal discounts to accelerate revenue recognition. Common market practices such as "limited-time discounts" and "bulk purchase incentives" are frequently used to facilitate real earnings management.

3.1.2. Related party transactions

Related party transactions involve transferring profits or expenses between the company and its affiliates. From the perspective of agency theory [5], management or controlling shareholders may abuse their power over related entities to maximize personal interests. Enron infamously used special purpose entities for off-balance-sheet financing and profit inflation, with 25% of its reported 2000 earnings stemming from fraudulent related-party transactions [6].

3.1.3. Asset restructuring

Asset restructuring typically includes structural adjustments, such as asset swaps, divestitures, or mergers to shift profits across periods and embellish financial statements. Fundamentally, when a company holds underperforming assets, selling these assets to related parties at inflated prices or divesting loss-making businesses can artificially boost short-term profits. However, such maneuvers merely cosmetic financial data without enhancing actual operational capabilities. A company's core competitiveness lies in tangible factors like technology, brand value, and market share. Relying solely on asset restructuring to improve profitability is fraught with risks. If underlying operations do not improve, the company's real financial condition will eventually surface, leading to profit reversals and undermining sustainable growth.

3.2. Measures of accrual-based earnings management

3.2.1. Adjustment of revenue and expense recognition timing

Under the accrual accounting system, companies often manage earnings by manipulating the timing of revenue and expense recognition. In terms of revenue, enterprises may recognize unearned revenue prematurely or fabricate sales contracts before meeting recognition criteria to include future revenue in the current period [7]. This practice artificially inflates revenue figures for specific accounting periods. Regarding expenses, companies may defer cost recognition or delay accruing payables to shift current-period expenses to future periods [8]. While these maneuvers do not alter long-term profitability, they distort the temporal distribution of earnings based on managerial

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interests, resulting in financial statements that fail to reflect the real operational performance of the business and potentially mislead investors.

3.2.2. Adjustment of fixed asset depreciation methods

Companies frequently adjust their earnings through changing the depreciation calculation methods or the service lives of fixed assets, and they adapt their methods according to the fluctuations of profitability cycles. During high-profit periods, many businesses employ accelerated depreciation methods to increase current expenses and reduce tax liabilities. Conversely, during periods of poor performance, they switch to the straight-line method to decrease depreciation expenses and boost reported profits.

4. Differences and application scenarios

4.1. Differences

Although both real earnings management and accrual-based earnings management are forms of earnings management, there are obvious differences between them. The most significant differences lie in their operational methods and economic consequences. Accrual-based earnings management alters profits across different accounting periods through legitimate accounting standards and appropriate financial processing methods, and it usually does not directly affect a company's cash flow or long-term business activities. However, the methods of real earnings management are completely different. Enterprises manipulate earnings by constructing transactions that change their normal business activities, which may have certain negative impacts on the long-term value of the enterprise. From the perspective of concealment, accrual-based earnings management will leave obvious traces in financial reports, while real earnings management manipulates earnings through actual economic activities, making it less likely to be detected by investors and regulatory authorities.

4.2. Application scenarios in different industries

Because of the variations in operational characteristics, market conditions, and competitive landscapes, the utilization of real earnings management and accrual-based earnings management varies considerably among different industries.

Given the significant proportion of fixed assets and the complexity of production processes inherent in the manufacturing industry, enterprises are more inclined to adopt real earnings management. On one hand, management may increase current profits by overproducing to reduce the unit production cost [3], thereby alleviating the pressure of performance commitments. On the other hand, manufacturing enterprises may also adopt measures such as providing sales discounts and relaxing credit policies to boost sales revenue. Take BYD Auto as an example. In the second quarter of 2025, to improve its quarterly performance, BYD implemented a series of promotional measures: launching substantial car purchase discounts and relaxing credit policies for auto loans... These measures attracted more consumers to buy cars, increasing sales revenue in the short term. Given that manufacturing enterprises' operations involve substantial physical assets and complex supply chains, related party transactions are correspondingly more prevalent. Enterprises may adjust profits through transactions such as raw material procurement and product sales with related parties [9].

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In the service industry, unlike the manufacturing industry, the proportion of fixed assets in its industrial structure is relatively small, with intangible assets such as human resources and technology being the main components. The production and sales process are relatively simple, so enterprises in this industry mostly use the method of revenue and expense recognition in accrual-based earnings management. In terms of revenue recognition, service enterprises may take advantage of the progress of service provision and the ambiguity of contract terms to recognize revenue in advance or delay it [10]. In terms of expense recognition, service enterprises may adjust earnings by manipulating the timing and amount of expense recognition. For instance, they may delay the recognition of employee training fees, travel expenses, and other expenses that should be recognized in the current period to the next period, thereby increasing current profits.

5. Disadvantages and adjustment measures

5.1. Disadvantages of real earnings management

5.1.1. Damaging long-term corporate value

Unquestionably, real earnings management can enhance the short-term attractiveness of a company's financial statements, thereby aligning with market or investor performance expectations. However, in the long run, it often severely undermines the company's core competitiveness and sustainable development capabilities, thereby reducing its long-term value [9].

Taking enterprises cutting research and development (R&D) investment as an example, there is no doubt that continuous R&D activities are crucial for a company's technological innovation and product upgrading. However, some enterprises reduce R&D investment to achieve short-term profit goals, which will undoubtedly lead to the loss of market share and weakened influence. Kodak, once a world-renowned imaging product company, dominated the film era. However, with the rise of digital technology, Kodak prioritized resources to maintain its film business to sustain short-term profits, leaving digital R&D on the margins for a long time [11]. Kodak's 2000 annual report showed that its R&D expenditure dropped from $922 million in 1998 to $784 million, with the proportion of revenue decreasing from 5.8% to 4.7% [11].

5.1.2. Increasing operational risks

The approach of real earnings management, which involves manipulating actual transactions, will inevitably set off a cascade of market and financial risks, thereby impacting the comprehensive operational risks of the enterprise. In terms of market risks, although implementing promotions and other means can increase sales in the short term, they may damage the company's brand image. Consumers may think that the product quality is poor or the company's operating conditions are unstable, which is why such frequent promotions are needed. As a result, customer loyalty to the product gradually weakens, and they turn to other competing products in the market, leading to a reduction in the company's market share. In terms of financial risks, overproduction will lead to a sharp backlog of inventory, occupying a large amount of funds, affecting capital liquidity, and thus facing breakage risks of capital chain. At the same time, it also reduces the company's investment in key areas, such as R&D and market expansion, gradually weakening the competitiveness of its products.

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5.2. Disadvantages of accrual-based earnings management

5.2.1. Reducing the quality of financial information

Accrual-based earnings management mainly adjusts profits by leveraging accounting policy choices and alterations in accounting estimates. Such practices are likely to undermine the authenticity and reliability of financial statements, ultimately diminishing the overall quality of financial information. When enterprises aim to achieve specific financial goals, they may choose unreasonable accounting policies. For example, in the selection of fixed asset depreciation methods, enterprises may deliberately choose a depreciation method that is beneficial to current profits.

5.2.2. Facing risks of review and supervision

Accrual-based earnings management mainly operates at the level of accounting processing, making it vulnerable to audit and regulatory reviews. When auditors audit financial statements, they usually focus on whether the company's accounting policy choices and accounting estimates are reasonable. If accrual-based earnings management behaviors are detected, auditors may issue audit reports with qualified opinions or adverse opinions. This will seriously affect the company's reputation and market image. At the same time, regulatory authorities will also strictly supervise the company's financial statements. If regulatory authorities detect accrual-based earnings management practices, the company will be required to promptly rectify the errors and face may severe penalties. Under the dual constraints of review and supervision, it will not only bring economic losses to the enterprise but also affect its reputation and market competitiveness.

5.3. Adjustment measures

5.3.1. Improving accounting standards and regulatory systems

To effectively restrict enterprises' earnings management behaviors, accounting standards and regulatory systems can be further refined and improved. In accounting standards, for example, in the selection of fixed asset depreciation methods, a more reasonable scope of depreciation methods can be stipulated according to the characteristics of different industries and the actual use of assets to restrict enterprises from arbitrarily changing depreciation methods. In the regulatory system, regulatory authorities should strengthen the review and supervision of enterprise financial statements, increase the frequency and depth, and also increase the punishment for illegal behaviors to raise the cost of enterprises' violations.

5.3.2. Strengthening internal corporate governance

A sound corporate governance is the foundation for enterprises to standardize operations and avoid excessive earnings management. Enterprises should establish a sound internal control system, clarify the responsibilities and powers of various departments and positions, and form an effective check-and-balance mechanism. In the decision-making process, supervision should be strengthened through the independence of the board of directors to prevent management from manipulating profits for short-term performance [12]. The board of directors should be independent of the management to prevent acting for personal interests and ensure the fairness of decisions. At the same time, the audit department of the enterprise is also crucial. Strengthening internal supervision is an important part of strengthening internal corporate governance. The audit department should

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regularly audit and evaluate the enterprise's financial statements and internal control systems, and timely discover and reveal existing problems. They should strengthen the professional ethics education of employees, improve their sense of integrity and responsibility, and encourage employees to actively participate in internal supervision, discovering and reporting illegal behaviors of the enterprise.

6. Conclusion

This study systematically explores the methods and impacts of enterprises manipulating profits through accrual-based and real earnings management. It is found that enterprises in different industries choose strategies based on their characteristics: manufacturing enterprises tend to adjust profits by expanding overproduction to reduce unit costs, and changing sales strategies; service industries mostly whitewash financial statements by means of advancing or delaying the recognition timing of revenues and expenses.

Specifically, real earnings management achieves its goals through real business behaviors such as regulating production and operation activities, manipulating related party transaction prices, and asset restructuring, and its impact penetrates into all aspects of enterprise cash flow and business chains, while accrual-based methods are mainly manifested in the subjective adjustment of the recognition timing of revenues and expenses, the change of fixed asset depreciation policies, etc. Such operations mostly act on the financial data level and do not directly change the actual business activities of the enterprise. Although these operations can achieve short-term goals such as performance and financing, they are more harmful in the long run: on the one hand, accrual-based earnings management will distort the authenticity and comparability of financial statements, making it difficult for investors, creditors and other stakeholders to accurately judge the real profitability of the enterprise, thus making wrong investment or credit decisions and exacerbating information asymmetry in the capital market; on the other hand, real earnings management often comes at the expense of the long-term interests of the enterprise, which will weaken the market competitiveness and reputation of the enterprise.

Despite the improvement of standards and supervision, management can still implement earnings management by taking advantage of the flexibility of rules. Therefore, curbing improper earnings management requires the joint efforts of multiple parties: enterprises should improve internal governance and give play to the supervisory role of the board of directors and regulatory departments; relevant national departments should formulate stricter accounting standards and regulatory systems to fundamentally maintain the quality of property information and promote the healthy and sustainable development of the capital market.

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