Research on the Quality Problems of New Accounting Standards’ Earnings

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Abstract. The earnings quality is the core of accounting information quality, which reflects the ability of information needs of different stakeholders satisfied by earnings information when making decisions. The new accounting standards have changed in terms of the concept of income, profit elements and definitions, profit recognition and measurement, the reporting and disclosure of financial statements and many others. What implications will result by these changes to the earning qualities? How to build a sound scientific analysis system under current standards to comment the earning quality of enterprises? Under the background of new accounting standards and international convergence, this article based on the institutional background, manipulate recognition and economic consequences three perspectives to review the current literature and dig its intrinsic links of earning quality and eventually build the quality analysis system by discussing the relationship of the core of business, financial perspective and non-perspective, earnings quality and profit ability three aspects.

The Statement of Problem

Since the Ministry of Finance published “Enterprise Accounting Standards---Basic Standard” in February 15, 2006 and corresponding 38 specific standards, the new enterprise accounting standards system continues being converged and innovative (Ge Jiashu, 2006). Especially after publishing “The Conferencing Road Map of Chinese Enterprise Accounting Standards and International Financial Reporting Standards” (Finance and Accounting [2010] No.10), the enterprise gradually formed the accounting standards conceptual framework and transferred from the income statement to liabilities of assets. In the process, changes in the profit report results in the change of profit structure and information content, like (i) No longer distinguish between the core and non-core business profits; (ii) Bring the ‘investment income’ project into the company’s ‘operating profit’; (iii) Adding new item ‘profit and loss from fair value changes’; (iv) Adding item ‘assets devaluation’ and others (Qian Ai’min, Zhang Xinmin, 2008). How to analyze the quality of profits based on the profit structure and evaluation of information content under the background of the new standards and convergence environment? How to consider the management of earnings and fraud profits’ influences on the analysis of earnings quality? Under the background of the new accounting standards and international convergence, this paper will analysis the questions of earning qualities from the point of view of profit structure and the ratio relationship, earnings management, the relationship between financial fraud and earning quality, influence factors and economic consequences, etc. and built the analysis framework of profit qualities.

Literature review

The Definition of Earnings Quality.

Earnings quality also known as ‘income quality’ or ‘profit quality’. Dechow, Ge and Schrand (2010) thought that the quality of profit report is determined by the enterprises’ financial performance itself and the accounting information system that including accounting standards, the industry regulator and other stakeholders to providing surplus figures. However, corporate shareholders and managers are likely to mask its financial achievement to seek and safeguard their certain interests by using the vulnerabilities of accounting information system such as maintaining
their reputation, access to credit, attract shareholders and so on. For example, the accounting standards allows the corporate management have some decision rights, they can make judgments and estimates for certain accounting assumption policies and expectations, resulting accidental calculation error or intentional manipulation of accounting numbers (such as earnings management).

**Old and New Accounting Standards Perspective: Different Institutional Background for Earnings Quality**

Comparing with the old accounting standards, the new accounting standards made a lot of adjustments on the regulations. On the basic research of earnings quality, scholars also adding the cooperation of earning qualities between old standards and new standards (Mao Xinshu, Dai Deming (2008); Liu Yuting, Wang Peng and Xue Jie (2009); Lu Z hengfei, Zhang Huili (2010); Qian Ai’min (2008)). Mao Xinshu, Dai Deming believe that improvement of the quality of financial report is the instinct factor to strengthen the robustness principle in the reform of accounting system. The improvement of the profit quality requires to improve the reliability and relevance of accounting information. The improvement of reliability refers to reduce manager’s estimates and judgement of accounting policies under the accrual accounting system, while the improvement of relevance requires continues the accounting recognition of incomplete transactions in accounting standards. After three years of the implementation of new accounting standards, Liu Yuting, Wang Peng and Xue Jie (2009) made the macro interpretation based on the 2009 annual financial report of Chinese listed companies. They believe that the implementation of the new accounting standards greatly improved the quality of accounting information such as the asset impairment accounting standards formulated the impairment policy and the impairment loss in long-term assets accrual cannot be reversed what greatly restricted the company’s inflated profits and others short-term behaviors. Another example is that the accounting principles ruled the company need to evaluate the possible relevant losses and offset its profits, which greatly avoid the company ahead distribution profits problem. It can be seen that the requirement in new accounting standards can improve the quality of profits to some extent. Lu Zhengfei, Zhang Huili (2010) analysis and comment on how to reasonable utilize the profit information under the new accounting standards and thought that the consolidated statements of net profit provided basic profit information for decisions of shareholders and creditors, while the net profit of the parent company statements have a complementary function. Qian Ai’min (2008) reconstructs the profit structure quality analysis system under the new standards, he stressed the important impact on the profit quality of three new concepts: core profit, narrow operating profit and generalized investment income.

**The Affecting Factors and Manipulation Measures of Profit Quality**

Many scholars studied the effects of non-financial factors on the quality of profits, mainly includes the ownership structure, corporate governance, political association and others. Wang Huacheng, Liu Tingli and Lu Chuang (2007) testified that ownership structure has a significant impact on the quality of profits. Cheng Songsheng, Lai Jiao (2013) made empirical tests and show the Enterprise Resource Planning system in those listed companies with low proportion stake, high ownership concentration and weak equity balance are more likely to exacerbate the company’s earnings manipulation, reducing the quality of its profits. The research of Ma Zhong, Cheng Dengbiao and Zhang Hongyan (2011) suggested that when the conflict level of company agency is high and the performance of achievement is low, the improvement of company’s internal governance could obviously improve the quality of profits. Bushman, Piotroski & Smith (2004) thought the transparency of the financial information the company announced is related with the political and economic behavior, and the government officials will reduce the transparency of information to conceal their interference behavior. Wang Xiuli, Zhang Xinmin (2005) thought the characteristics of the profit structural quality should include the following aspects: the compliance of profit structure and business development strategy, the core value of the main business, the harmony of the profit structure itself, the matching of the profit structure and the asset structure, the convergence of the profit with the cash flow structure.
Reconstruction of Core Profit Quality System under the New Accounting Standards

Profit Quality Analysis Based on the Core of Business

The current accounting standards no longer distinguish the main business revenue and other service incomes and all combined with the cost and listed in the operating incomes and operating costs. Companies still need to separately considered the incomes and costs of the main business and other services, when writing the financial statements, only the profits of the main business can be regarded as core profits, while the profits of other services and other items like asset impairment losses, changes in fair values and investment income belongs to non-core profit and in the annotation separately disclose the proportion of core profit, core business and business strategy and other aspects. This is because the core profit should be the direct profit produced by the use of operating assets in their own operating activities. If the range of the core profit is expanded, the company’s operating assets, core profit and the net cash of the operating activities will become blurred and it is not conducive to analyze the intrinsic links between the financial statements items.

Analysis of the Profit Quality Based on the Financial and Non-financial Perspectives

The implementation of the new standards not only meet the investors’ certain information needs, but also created some space for corporate earnings management. Under the current standards, companies can use various means to manipulate profits and whitewash financial reports. Therefore, when evaluating the quality of profits, we should pay more attention to profit structure and the external and internal profit ratio, and focus on the structural and timing sequence of the profit structure in the recognition process. However, mere from the financial perspective analysis is inadequate to judge the pros and cons of the profit quality, so I think that the company need combined the analysis of non-financial perspectives like if the profit structure is matches its industrial strategy, profit structure and business synergies effect, profit persistence and executive incentive and others. Through the organic combination of the financial and non-financial perspectives, the investors could comprehensively learn and understand companies’ industry background, its places in the industry and many other aspects and make right decisions.

The Reconstruction of Profit Quality and Profitability Analysis Index under the New Accounting Standards

I think it should comprehensive consideration by compared the profitability with the industry, its own history and the reasons of the change, and its corresponding industrial strategy, future profitability that is to say the sustainability of the profit and other aspects, the specific indicators are shown as follow:

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*Profitability means stable return investment capacity provided by the core profit under the conditions of continuing operations; earnings capacity means the return capacity provided by core and non-core profits under the continuing operations.

**References**


