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The Influence Of Earnings Management through Real Activities Manipulation: Evidence from the Coronavirus Period

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Abstract

Under the background of COVID-19 climate, many companies are unable to operate normally and even face the threat of bankruptcy. How to survive and even make profits during the epidemic period is an important issue for many enterprises. Based on the current epidemic situation, this paper analyzes various methods of real earnings management and discusses how these methods affect the expense and revenue of the companies. Compared with the previous normal period, we find that the main purpose of managers using real activity manipulation under this hard time is different, which is to help companies reduce losses and avoid bankruptcy. In addition, although not all methods can achieve the managers' profit target, the use of real activity manipulation is more pervasive during the epidemic period.

Keywords

Manipulation of real economic activities; Real earning management; Coronavirus.

1. Introduction

With the continuous spread of the epidemic, the global economy has been affected and many enterprises have been forced to shut down and face bankruptcy crisis. Therefore, some managers use real activities manipulation to help companies reduce losses and avoid bankruptcy efficiently [1].

Real activities manipulation which has been researched by the escalating number of studies is used greatly in the accounting field. According to the evidence found by Roychowdhury (2006), managers manipulate actual activities to avoid losses in the reporting year or achieve analysts' expected profits, which makes stakeholders believe that the earning of company is stable or the company is worth investing [2]. The prior research focused almost exclusively to the practice of accounting earnings management in the normal period. Therefore, the paper aims to investigate the role of real management manipulation and summarize some relative methods to help more companies survive and even make profits during the epidemic period.

In the work, we highlight some certain methods of real activities manipulation which help companies reduce losses and avoid bankruptcy efficiently, and the relative consequences of such methods. Our paper proceeds as follows. Section 2 presents the motivation underlying the studies and research question. Section 3 deals with the detailed process of real activities manipulation and relative change shown on financial statement. A discussion of the adverse effects of real activities manipulation during the outbreak will be the subject of section 4. Section 5 covers our findings in terms of the this management tool. The last section concludes the paper.

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2. Motivation and Research Question

During the epidemic period, the consumption level drops significantly. Since February, a large number of large-scale enterprises have been closed, and smaller, and medium-sized enterprises have defaulted on wage payment, resulting in the shortage of people's income. In addition, the government requirement of self-isolation and the on-time-arrival loans and credit bills force people to cut back on spending [3]. The shrinking consumption level makes many companies face the risk of income decline or even bankruptcy. Therefore, in order to avoid more economic losses and survive in this hard period, the company's managers have to come up with many ways to protect themselves. Real earnings management (REM) is the most commonly studied earning management tool discussed largely in the previous research. Therefore, this paper will discuss how REM is used by managers to save themselves during the outbreak.

3. Various Forms of Real Earnings Management

3.1. Sales manipulation

Sales manipulation is one of the the main method to manage earning through real activities manipulation, and defined as the managers' attempts to increase sales and earnings during the fiscal year by providing limited time discounts or more lenient credit terms [2]. Both methods have been used extensively by managers to avoid losses and keep earning smoothing during the outbreak.

The first way is that the company offer increased price discount in order to to generate additional unsustainable sales or accelerate the sales from the next fiscal years into the current years [2]. During the epidemic period, the time with poor profitability, many enterprises have discounted their goods and services. Especially, the months in the middle of year is the period when many enterprises will publish their semi annual reports. Therefore, in order to make the semi annual reports more stable under these two reasons, a lot of companies have made great efforts to discount their products. There is an example of discount on services comes from a British train company, LNER, as the epidemic slowly eased. In August, LNER introduced 50,000 discounted rail tickets called LNER Flat Fare Single Ticket, which are on sale from Monday to Thursday every week [4]. The higher price discount, roughly 70%, effectively prompt the sales of rail tickets and people' trip volume in UK, which can boost earning to the company financial statement.However, this sales manipulation method will not be used by all enterprises in the epidemic. For example, there is no sales pressure in the medical industry in this time of heavy need for medical supplies, and the luxury goods industry will not choose to discount their own products, which will take adverse effect to the brand reputation.

The second method to manipulate sales mentioned above is to provide more lenient credit terms. An example is given by Roychowdhury (2006) that retailers and automobile manufacturers offer lower interest rates toward the end of fiscal year, which is essentially price discount to increase the sales volume and earnings [2]. However, if the suppliers to firm do not provide the matching discount, the cash inflows will be lower [2]. During the epidemic, some automobile suppliers' lenient credit terms will help attract customers and boost sales, such as extending the repayment period and lowering interest rates

3.2. Discretionary Expenditure

The second form of REM discussed by this paper is the reduction of discretionary expenditure, where the expenses include R&D, advertising, and SG&A expenses. Reducing the discretionary expenditure which cannot directly and immediately generate income and revenues will increase the the current period earnings to meet the manager's target [5].

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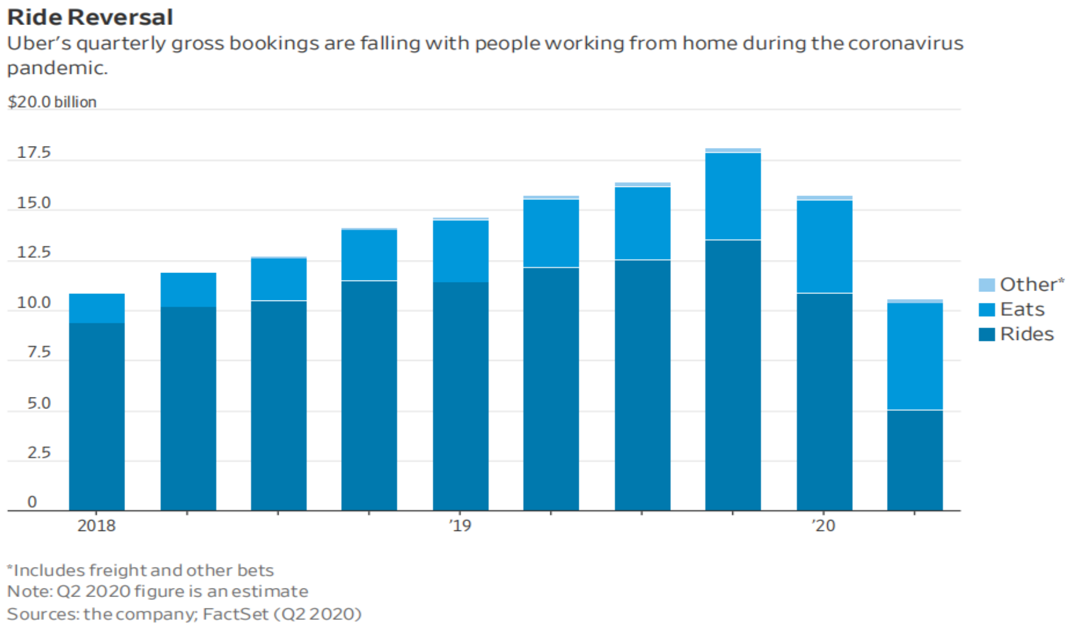

Figure.1 Ride Reversal

Table.1 Uber Technologies, INC. condensed consolidated statements of operations
(In millions, except share amounts which are reflected in thousands, and per share amounts)
(Unaudited)

	Three Months Ended June 30,		*Six Months Ended June 30,*	
	2019	2020	2019	2020
Revenue	$ 3,166	$ 2,241	$ 6,265	$ 5,784
Costs and expenses				
Cost of revenue, exclusive of depreciation and amortization shown separately below	1,740	1,252	3,421	3,038
Operations and support	864	582	1,298	1,085
Sales and marketing	1,222	736	2,262	1,621
Research and development	3,064	584	3,473	1,229
General and administration	1,638	565	2,061	1,424
Depreciation and amortization	123	129	269	257
Total costs and expenses	8,651	3,848	12,784	8,654
Loss from operations	(5,485)	(1,607)	(6,519)	(2,870)
Interest expenses	(151)	(110)	(368)	(228)
Other income(expenses), net	398	(44)	658	(1,839)
Loss before income taxes and loss from equity method investments	(5,238)	(1,761)	(6,229)	(4,937)
Provisions for(benefit from) income taxes	(2)	4	17	(238)
Loss from equity method investments	(10)	(7)	(16)	(19)
Net loss including non-controlling interests	(5,246)	(1,772)	(6,262)	(4,718)
Less: net income(loss) attributable to non-controlling interests, net of tax	(10)	3	(14)	(7)
Net less attributable to Uber Technologies, Inc.	$ (5,236)	$ (1,775)	$ (6,248)	$ (4.711)
Net less per share attributable to Uber Technologies, Inc. common stockholders:				
Basis	$ (4.72)	$ (1.02)	$ (7.97)	$ (2.72)
Diluted	$ (4.72)	$ (1.02)	$ (7.98)	$ (2.72)
Weighted-average shares used to compute net loss per share attributable to common stockholders:				
Basis	1,110,704	1,738,897	783,900	1,731,632
Diluted	1,110,704	1,738,897	783,982	1,731,632

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During the challenging COVID-19 climate, a low consumption level period, many companies are in their hard time. Their revenue have shrank sharply and income have evaporated. Therefore, this form of REM is more pervasive used by the managers to avoid more expenses or even bankrupt. A typical Uber news reflects the use of this form of REM. According to a Forbes news in May, Uber shed 6700 employees within a month's time, roughly a quarter of its workforce, at total 28600 employees [6]. Due to the restrictions on trip and the reduction of people's willingness to trip, the uber's quarterly gross booking are falling, approximately from 15.5 to 10 billions booking (figure1). Figure 1 shows the quarterly gross booking of Uber from Q1 2018 to Q2 2020 and the Q2 2020 figure is an estimate [7]. Therefore, there is not enough work of front-line customer to support employees. The layoffs effectively reduce the general and administrative expenses to $565 millions for the quarterly period ended June 30, 2020, a decrease of 65% compared with the same period last year. In addition to general and administrative expense, the company also reduced other discretionary expenses, including a 81% drop in research and development expenses and a 40% drop in sales and management expenses over the same period (table1). Table 1 shows the the expenses in Q2 of 2018 and 2020 [8]. The use of this earning management tool effectively avoids more loss and keep the earning smoothing with less earning fluctuation. The comprehensive loss attributable to Uber Technologies, Inc. of the second quarter of 2020 is $2024 millions, a increase of 61% compared to the same period loss in 2019, at $5157 millions (table2). Table 2 shows the comprehensive loss in Q2 of 2019 and 2020 [9].

Moreover, the reduction of discretionary expenditure is not an individual case. Since the outbreak, a number of companies have announced their layoff decision. For instance, the Airbnb downsize 25% of its workforce, roughly 1,900 people out of the company's 7,500 total [6]. Therefore, the reduction of discretionary expenditure is not only pervasive, but also expands the scale of use during this challenging time.

Table.2 Uber Technologies, INC. condensed consolidated statements of comprehensive loss (In millions) (Unaudited)

	Three Months Ended June 30,		*Six Months Ended June 30,*	
	2019	2020	2019	2020
Net loss including non-controlling interests	$ (5,246)	$ (1,772)	$ (6,262)	$ (4,718)
Other comprehensive income(loss), net of tax:				
Change in foreign currency translation adjustment	71	(257)	17	(405)
Change in unrealized gain(loss) on investments in available-for-sale securities	8	8	4	(52)
Other comprehensive income(loss), net of tax	79	(249)	21	(457)
Comprehensive loss including non-controlling interests	(5,167)	(2,021)	(6,241)	(5,175)
Less: comprehensive income(loss) attributable to non-controlling interests	(10)	3	(14)	(7)
Comprehensive loss attributable to Uber Technologies, Inc.	$ (5,157)	$ (2,024)	$ (6,227)	$ (5,168)

3.3. Other Forms

Another form of REM will be discussed is overproduction, which increases the production to meet the expected demand. When company produce higher level of production, the fixed overhead separated into every unit production will be reduced, resulting in lower COGS and better operating margin [5]. However, this form of REM will not used by the most of companies except for pharmaceutical companies, medical device companies, which need a large scale of production in an epidemic. People's consumption level decreases during the epidemic period; Therefore, the overstocking of goods is actually the current problem, and overproduction would only make the current problem more serious.

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The final REM discussed by this essay is sales of long-term assets. According to the journal of Bartov (1993), many company with negative incomes will sell the assets to obtain higher earning [10]. For example, Uber closed 45 offices as a method to avoid losses, which will indirectly lead to the sale of long-term assets, such as offices and furniture in the offices [11]. The sales of assets can bring additional income to the company and high restructuring expenses which will be discussed in the next section. There are many cases which sell the long-term assets to survive because of no financial support in the epidemic period, but the reason for buying assets is not just to boost earning, which will be mentioned in the findings.

4. Adverse Effects

While the above finding is consistent with companies survival or even profit , it is also consistent with some negative impacts on the development of those firms that manipulate real activities to boost earnings. To explain these certain resistance, we refer to the relevant papers which has confirmed such claims by an array of supplementary tests. First, managers use such method to control certain revenue or expense at the expense of a high cost [12]. For example, cutting R & D expenditures to manage revenue may result in future revenue losses associated with abandoned R & D opportunities.

On the other hand, because the manipulation of actual activities does not violate GAAP, the testing cost of this earnings management tool is expected to be lower than that of accrual management.

Besides, though manipulating real activities, once the company announced the manipulation of profits, the company's share price fell sharply.Consistent with Feroz etal. (1991), they find a significant drop in the manipulating firms' stock prices at the announcement of the earnings manipulation [13]. Also, Cristhian Mellado-Cid examined the authenticity of the hypothesis that firms with higher valuations will be associated with lower earnings management and firms with lower valuations will be associated with higher earnings management [14].

5. Main Findings

Based on the above analysis of REM in the epidemic period, this paper summarizes four main findings. Firstly, not all the methods are practical to meet the earning target by managers during the outbreak. For example, the method that manipulating sales and reducing discretionary expenditure is efficiently to manage the earning and keep the earning smoothing; however, the method, overproduction are less practical for most of the sales company to improve earning except the company operating normally in this hard time.

Next findings is relative to main purpose of using REM, which is that some forms of REM are literally effective and efficient in helping companies reduce their losses. According to an above example from Uber, the comprehensive loss attributable to Uber Technologies, Inc. of the second quarter of 2020 is $2024 millions, a decrease of 61% compared to the same period loss in 2019, at $5157 millions.

The third findings is that the motivation of using REM by manager are different from this challenging period and previous normal period. The incentive of using the tools to manage earnings by managers during this hard time is mainly to decrease losses and avoid bankrupt, which is more like that the manager have no choice to make this decision. By contrast, mangers using REM in the relatively stable period is more autonomous, like meeting earnings management threshold and maintaining earnings smoothing.

The final findings in this paper is that the use of REM is more pervasive and deeply in this period. An example indicates that Uber's CEO Mr. Khosrowshahi laid off more than 1100 employees in

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2019 for a better operation of company but laid off 6700 employees in 2020 for the survival in the COVID-19 climate [11].

6. Conclusions and Suggestions for Further Research

This paper aims to investigate the influence of earnings management through real activity manipulation during the outbreak. Specifically, this paper, analyzes various methods of real earnings management and discusses the relative effects by providing a series of evidences. We find that compared with previous normal period, the real activities manipulation are literally effective and efficient in helping companies reduce their losses to avoid bankrupt and the motivation of using REM by manager is not autonomous during this hard time. Although the evidences show that not all methods can be used to achieve the managers' profit target, it is clearly that managers use real activity manipulation more widely and deeply during the epidemic period.

In addition, the paper summarize some relative methods associated with real activities manipulation which might be helpful for those companies struggling with survival during the epidemic period.

However, the analysis of real activity manipulation during the epidemic period is still not mature enough. Because the epidemic is still continuing, we do not have total data to support our findings. In addition, due to the persistence of the epidemic, we are unable to analyze the extent and overall impact of real activity manipulation by companies at each stage of the epidemic. After the end of the epidemic, these aspects are worthy of comprehensive discussion in the future.

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