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Timing earnings

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ABSTRACT

Since the opening of China's securities market, there have been a number of bull and bear cycles. This paper discusses how executives use the market timing approach to manage earnings in different cycles to maximize firm value. We find that Chinese listed companies choose to release more earnings during bull markets and this phenomenon is more evident in companies that are more profitable and have higher valuations. We also find that executives who do not release more earnings during bull markets are more likely to be dismissed.

1. Introduction

Earnings management has long been criticized because it causes conflicts of interest between parties to economic contracts. The negative results of these conflicts appear as

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management fraud, accounting information distortion, business failures and loss of investors' trust in capital markets. However, the concept of earnings management derived from Western theories is neutral. Professional judgment is important during the production process of earnings information. Poor judgment leads to adverse economic consequences, whereas reasonable judgment can provide more useful earnings information (Wang and Zhao, 2003). Two main ideas have emerged from empirical studies of earnings management: opportunistic behavior and efficient contracting perspectives. Based on John Rawls' principles of justice and the assumption of individual rationality, Chen (2009) uses contracts as the starting point of analysis and proposes that the efficient contracting perspective (efficient perspective) is not empirically researchable, and the opportunistic behavior perspective is not a necessary concept in empirical research. He further suggests that moral judgment should be excluded from empirical research into earnings management. Instead, it is important to develop theories of earnings management based on a contracting perspective.

Currently, there is considerable interest in earnings management research, especially in the motivation for earnings management, such as bonus plans (Healy, 1985; DeAngelo, 1988; Dechow and Sloan, 1991), contract-based motivations (Healy and Palepu, 1990; Sweeney, 1994; DeAngleo et al., 1994), political costs motivations (Cahan, 1992; Key, 1997) and capital market-based motivations (Healy and Wahlen, 1999; Dechow and Skinner, 2000). However, previous studies report that motivations of earnings management concentrate on firm-specific factors and few studies have investigated the effect of periodic fluctuations in the stock market on earnings management. Does the market-timing phenomenon that is widely observed in investment and finance also exist in the release of accounting earnings information by listed companies?

In the long run, the stock market experiences periodic cycles of boom and bust, or bull and bear markets, under the combined effects of economic cycles and policy cycles. Under the bull cycle, supply falls short of demand in the stock market, market participants generally hold high expectations of the future earnings of companies and low uncertainty of firm values, and information asymmetry is low. However, under the bear cycle, supply exceeds demand, market participants hold lower future earnings expectations and high uncertainty of firm values, and information asymmetry increases. Listed companies, as micro-economic subjects and suppliers of stocks (i.e., security market products) and accounting information, may show different characteristics in the production of accounting information based on adverse selection, supply and demand relations, and market reactions, and decide to release earnings under different market cycles. Thus, this paper provides preliminary evidence on the timing of earnings under different market cycles.

We find that Chinese listed companies choose to release more earnings during bull markets. This phenomenon is more evident in high-profit enterprises and companies with higher valuations. Finally, we find that executives who do not release more earnings during bull markets are more likely to be dismissed.

Few studies have evaluated the relationship between stock market cycles and earnings management. This is one of the first studies to examine how firms manage earnings in different market situations. These findings enrich the literature on market timing and earnings management and increase our understanding of interactions between the stock market and firm behavior.

The remainder of this paper is organized as follows: Section 2 reviews the related literature and discusses the institutional background and theoretical analysis. Section 3