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EARNINGS MANAGEMENT AND THE ASYMMETRY IN DISTRIBUTION OF EARNINGS: SLOVAK EVIDENCE

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Abstract
Businesses manage results to avoid low losses and low profits. Results confirm significant anomalies. Analysts are much more likely to predict zero revenue than their firms actually achieve and analysts are unable to consistently identify specific firms that apply such techniques to prevent this. One of the means by which profits can be managed is reserves and the release of unjustified reserves. As information on the reason for the release of provisions (due to their use or due to their unfoundedness) is not provided, they are broken down in financial statements.
Balanced policy applied during the accounting period and in the preparation of financial statements, the company's management significantly affects the content, structure and explanatory power (information function) of the accountant statements. The entity's balance sheet policy has two basic objectives – Influencing external users of financial statement information in making their decisions (related to accounting policy) and income tax optimization (related to tax policy).
In this article we tested whether there is a significant share of high losses in the transition from profit in one year to loss in the second year and that companies in a given sector try to keep the ROI at the average level of the given sector and when there is a loss, the companies report the loss already in the proper amount. Several authors found in their analyzes that this ceased to apply but we found out that in the Slovak environment, this statement is valid for approximately 60% of companies.

Keywords: *annual report, earnings management, returns on investment*

1. INTRODUCTION

As defined in International Financial Reporting Standards, "financial statements are a structured representation of the financial position and financial performance of an entity" (Pakšiová, & Janhuba 2012). The objective of the general purpose of financial statements is to provide information to a wide range of users in making economic decisions. Financial statements also show the results of a management´s stewardship with the resources entrusted to them (Kurnaz et al., 2010). Misstatements arising from fraudulent financial reporting are intentional misstatements or disclosures in financial statements designed to deceive financial statement users (Ondrušová, 2011).

Earnings management examination is a methodology for resolving fraud allegations from inception to disposition. More specifically, earnings management examination involves obtaining evidence and taking statements, writing reports, testifying to findings and assisting in detection and the prevention of earnings management.

Empirical studies provide evidence of existing management earnings techniques that can be detected by analyzing financial statements (Andrejovská, & Banociová, 2013). Nevertheless, the recent high-profile financial reporting failures rioted that especially earnings

management caused the bankruptcy of companies. On whether this preposition remains valid. Indeed, many authors interpret the step upward trend during the most recent years in accounting, other authors propose arguments on the underlying reason for the apparent erosion in financial statements quality.

There are many reasons why earnings management techniques are used – companies try to get as many investors – by for example; creating the illusion of higher dividends (if the profit is high) or above-average capital appreciation (if they increase the value of assets and / or increase the profit too) and other companies are aimed at calculating the lowest taxes (Parajka, 2015). Despite their objective existence this does not necessarily mean that managements deliberately chose balance sheet policy that will better suit their purposes, on the other hand, the risk of such condition is substantially higher (Kontsyvaya et al., 2019). For these reasons, it is then appropriate to reach beyond indicators of possible distortion.

2. LITERATURE REVIEW

Recent research confirms that a disproportionate amount of companies barely report profits, earnings increases over last year´s earnings, and positive earnings surprises relative to analysts´ expectations.

Lahr (2013) in his paper improved methods developed by Bollen and Pool (2009) and Burgstahler and Dichev (1997) and analyzed earnings of US companies during the period 1976–2010. Earnings data used in this study showed a discontinuity at zero for standardized earnings and earnings changes. Their results show a large drop in loss aversion after 2003.

Prior research confirmed (Cohen et al., 2008) that introduction of Sarbanes-Oxley Act caused that accrual-based earnings management to decline. Based on empirical evidence from Japan (Enomoto, & Yamaguchi, 2017) it was found that discontinuity in the distribution of earnings changes before Sarbanes-Oxley Act was caused by habitual beaters; and after the Sarbanes-Oxley Act implementation habitual beaters to avoid earnings decreases was less prevalent.

Another study analyzed the relationship between corporate bond credit spreads and significant risk warnings in Chinese companies' annual reports. (Xi, Wang, & Furong, 2019).

Some studies use benchmarks for predicting earnings management. In Kent, Rutledge paper (2017) have used different approaches to identify whether earnings benchmarks are an indicator for earnings management in the Australian market and their results confirm and provide evidence of earnings manipulation around small positive earnings benchmarks. However that does not identify any evidence that the positive earnings change benchmark is a signal for earnings management.

Hansen (2010) study examines whether firms with small losses and small profits have differing levels of discretionary accruals. Companies just above the benchmark have significantly higher discretionary accruals and that provides proof that the difference in the distribution of earnings arises from earnings management. These results are helpful for those who do not find results consistent with earnings management when such results are predicted by theory.

Another study focuses on small and medium enterprises (Chiang et al., 2011) and tested whether these companies perform earnings management (analysis was on a data sample from years 1997 to 2003). This study confirmed by using chi-square tests that in companies which incurred a minor loss, the earnings were manipulated to slight positive earnings.

Christadoulou and Mc Leay (2009) scaled the earnings variable by the magnitude of its own components, restricting the standardized range to (-1,1). In their paper they argue against the hypothesis of distribution, which is smooth in the region around zero, and instead expect an

inherent asymmetry in profit and losses. They conclude that wrong statements are usually used in literature and that there are both smaller profit observations and fewer small loss observations than expected.

Dechow, Richardson and Tuna (2003) analyzed whether the boosting of discretionary accruals to report a small profit is a reasonable explanation for the statement that too few companies report small losses and too many companies report small profits. Based on their results we can say that both groups (small profit and small loss companies have similar levels of discretionary accruals and similar proportions of positive discretionary accrual companies.

Monte Carlo simulations were used in a study done by Garrod, Pirkovic and Valentincic (2005) on a sample of 5000 observations. Based on this the hypothesis of continuity for distribution functions with jumps is rejected whilst for continuous distributions it is not.

A study made by Gore, Pope, Singh (2007) examined earnings management before and after the issuance of FRS3 on a large sample of UK companies and provided new evidence on discontinuities in the distribution of reported earnings. They confirmed the distribution of earnings does not reflect the unusually high frequencies of small surpluses and unusually low frequencies of small deficits before and after discretionary working capital accruals.

A study that analyzed British and French companies (Halaoua, Hamdi, & Mejri, 2016) found out that the size of the companies and corporate governance structure have a positive effect on earnings management. Earnings management is more prevalent in British companies.

Jacob and Jorgensen (2007) investigated earnings management distribution in fiscal year earnings by aggregating quarterly earnings over annual periods and comparing them with fiscal year earnings.

Jiang (2008) investigates whether beating these three earnings benchmarks reduces a firm´s cost of debt and also investigates under what conditions. The study identifies a significant benefit of beating benchmarks reducing the cost of debt and shows the importance of beating the various earnings benchmarks is different in the debt market than for equity markets. The study provides the first evidence of a discontinuous relation between credit ratings and earnings information around the three benchmarks.

3. METHODOLOGY AND DATA

The objective of this paper is to examine whether earnings management methods were used by companies in Slovak republic by analyzing their financial statements for the period 2011–2018. According to the objective of this paper we proceeded as follows:

- Analyzed available data,
- Created a hypothesis,
- Tested the hypothesis,
- Refined and amended the hypothesis.

Tools used for examination of earnings management existence were used to analyze financial statements data. The purpose of earnings management examination is to prove or disprove the legal elements of the offence.

The paper examines the following hypotheses:

H1: There is a significant share of companies which report high losses in the transition from profit in one year to loss in the second year.

H2: The companies in a given sector try to keep the ROI at the average level of the given sector and when there is a loss, the companies report the loss in the proper amount.

The sample includes all Slovak companies' data for years from 2011 to 2018 obtained from the www.registeruz.sk database with financial statements.

Table 1. Research sample

Year	No. of financial statements
2018	219173
2017	208228
2016	198414
2015	190486
2014	186348
2013	166269
2012	90451
2011	96535

Source: Own processing

We analyse earnings management from actual reported annual earnings. We calculate ROI (return on investment – ratio calculated as a share of profit or loss and equity) of companies to find average of each sector and then we calculate ROI of all companies with profit/loss up to 1000 eur. Last step is to compare ROI of companies with small profits or small losses with average ROI of all companies divided by the sectors.

4. RESULTS AND DISCUSSION

The following table shows 208 228 financial statements for the accounting periods 2017 and 2016. Based on the data in the table, it is clear that the share of companies which show low losses or profits is approximately 20%. Of this number, only 30% of companies reported low losses or profits also in the following year.

Table 2. Number of companies with low losses or profits for years 2016 and 2017

Sector	Year 2016	Year 2017
Automotive industry	30	11
Tourism and gastronomy	2336	844
Transport and logistics	1423	474
Wood and paper	415	143
Electronics	209	71
Energy and mining	99	47
Finance	1051	391
Hazard	30	11
Chemistry	174	68
Information technologies	1892	663
Metal production and metallurgy	609	190
Retail	4193	1686
Media, publishing, and culture	694	228
Property	2647	1070
Clothing and footwear	236	78
Agriculture and forestry	825	357
Food	337	119
Law, consulting, accounting	4181	1657
Sale and maintenance of vehicles	651	222
Design and engineering	1157	397
Advertising	1035	390
Services	3478	1383

Waste treatment	103	44
Mediation	2289	1087
Construction	4465	1415
Engineering	274	99
Education and Training	596	195
Telecommunication	118	47
Wholesale	3034	1339
Government	5	1
Production	174	68
Development and Testing	535	183
Health Service	960	276
Total	40 256	15 254

Source: Own processing

Almost identical results were achieved from the financial statements in all analyzed years 2011–2018. In the following table it was analyzed whether companies in a given sector try to keep the ROI at the average level of the given sector and when there is a loss, the companies report the loss in the proper amount. This hypothesis was also confirmed. As we can see in the following table (processed all annual reports in Slovak Republic for the year 2017). ROI (return on investment – ratio calculated as a share of profit or loss and equity) of all companies with profit/loss up to 1000 eur is close to the total ROI in every sector (the only exception is in the Energy and Mining sector, but there were only a few financial statements available so we classified this exception as insignificant).

Table 3. ROI of Slovak companies for year 2017 classified by sector

Sector	Total ROI	ROI of profit companies	ROI of non-profit companies	ROI of companies with profit/loss up to 1000 €	ROI of companies with profit/loss over 1000 €
Automotive industry	-0,37525777	0,108598177	-1,205846817	-0,370269646	0,001400587
Tourism and gastronomy	-0,656311309	1,086114576	-2,273794635	-0,559990647	-0,002732026
Transport and logistics	-0,830568402	0,22130983	-2,510400874	-0,762487609	0,061854421
Wood and paper	-5,300367125	0,31451486	-14,13598898	-5,287718596	0,001156814
Electronics	-0,10066377	0,206831971	-0,863313188	-0,09915803	-0,010586288
Energy and mining	-0,552186546	0,097270494	-1,736511742	-0,084809691	0,016026382
Finance	-0,444420808	0,285858987	-1,662748219	-0,381269906	-0,003003843
Hazard	-0,06094136	0,182725101	-0,614549196	-0,007187974	0,012941189
Chemistry	0,793328043	1,934851217	-0,849853113	0,852238517	-0,003829382
Information technologies	-0,36283445	0,377266786	-2,080662906	-0,284298095	0,001429957
Metal production and metallurgy	-1,099148939	1,179888429	-6,452200367	-1,024918131	-0,007063753
Retail	-1,116619879	0,612107634	-3,141723853	-0,94461214	0,006392856
Media, publishing, and culture	-0,315539489	0,327584494	-1,549566741	-0,244724952	-0,004783408
Property	-1,873668828	1,867745767	-6,473009368	-1,739214557	0,008967885
Clothing and footwear	-0,891829197	0,157069569	-2,404697783	-0,819549663	-0,002782664
Agriculture and forestry	-1,560926584	0,154036319	-4,444137629	-1,347401188	-0,002882685
Food	3,10489448	9,052481871	-2,646195794	3,306137608	0,01093003
Law, consulting, accounting	-0,509736747	0,462265201	-2,359443736	-0,441432015	-0,014447351

Sale and maintenance of vehicles	-0,505709111	0,784491166	-2,135425782	-0,226641112	0,009354213
Design and engineering	1,230061138	2,272342559	-0,909420027	1,288711513	-0,008483868
Advertising	-0,600476423	0,384526875	-2,24916384	-0,581238223	-0,00342135
Services	-0,660191508	0,278049729	-2,029984469	-0,493762595	0,00144629
Waste treatment	-2,554671678	0,146327044	-7,495087084	-2,435035087	-0,024595564
Mediation	-1,451424711	0,416672283	-3,788922649	-1,190726138	0,036689171
Construction	-0,718814214	0,364473844	-2,769384494	-0,678345628	-0,015708934
Engineering	0,136674064	0,677987106	-0,969427318	0,143413011	-0,023417082
Education and Training	-0,687410307	0,407557941	-2,552628999	-0,600762085	-0,0300309
Telecommunication	-2,722164636	0,168602262	-10,68987869	-2,693952179	0,00270708
Wholesale	-13,8188935	0,519083059	-35,7734747	-13,59909894	0,013047735
Government	-0,025001824	0,105540562	-0,158044391	-0,006621648	-0,009927062
Production	3,159479667	6,636224617	-0,910390267	3,232687869	-0,00404571
Development and Testing	-0,234063449	0,290424361	-1,24118381	-0,158408058	-0,005380419
Health Service	-0,150130924	0,209663843	-1,365683326	-0,080194302	-0,00590965
Total	-1,77652013	0,70015064	-5,783759656	-1,659617753	0,001929269

Source: Own processing

Almost identical results were achieved from the financial statements in all analyzed years 2011–2018. We found significant trends in both profits and losses, a greater frequency of small losses and profits that meet ROI sector average in every year. And we found a significant trend in alternation of small profits and losses with high ones, so when companies report the loss they report it in significant amount – in every year is this statement valid for approximately 60% of companies in Slovak Republic.

5. CONCLUSIONS

One of the main challenges in identifying earnings asymmetry is that the existence of indicators of earnings distortions do not always necessarily indicate the occurrence of manipulation (intentional bias), but further investigation of these anomalies is needed. In particular, it is important to bear in mind that management may have a natural affinity for riskier or less risky solutions.

Our paper confirms both hypotheses – there is a significant share of companies which report high losses in the transition from profit in one year to loss in the second year in Slovak Republic – about 60%, this was confirmed in every period from 2011 till 2018. Also another hypothesis was confirmed – there are companies in a given sector which try to keep the ROI at the average level of the given sector and when there is a loss, these companies report the loss in the proper amount.

This analysis is important due to fact that analysts can anticipate earnings management due to existence of small losses or small profits and identify the specific companies that engage earnings management.

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