

A Review of the Impact of “High Deposits and High Loans” on Earnings Management from the Perspectives of Financing Constraints and Equity Financing Dependence

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Abstract

In recent years, abnormal financial behaviors of enterprises with “high deposits and high debts” have occurred frequently in the capital market, damaging the transparency of accounting information and the credibility of the accounting industry. “High deposits and high debts” refers to the phenomenon where enterprises have both high deposits and high debts, and it often intertwines with the profit management motives of the management. This paper, from the dual perspectives of financing constraints and equity financing dependence, systematically reviews domestic and foreign literature, clarifies the formation mechanism of “high deposits and high debts” and the cutting-edge theories of profit management, and deeply analyzes its transmission mechanism. The research shows that financing constraints and equity financing dependence are the two core paths driving “high deposits and high debts” enterprises to implement profit management: the former forces enterprises to conceal financial crises to obtain financing, and the latter drives enterprises to conform to market expectations to promote refinancing. The case of Dongfang Group, etc., also validates this mechanism. Finally, this paper points out the shortcomings of existing research and proposes future directions. This study not only enriches the theoretical system of financial anomalies and profit management, but also provides practical references for investors to identify risks, regulatory authorities to formulate prevention strategies, and enterprises to optimize capital allocation.

Keywords

dual high phenomenon of deposits and loans, earnings management, financing constraints, reliance on equity financing, financial fraud

1. Introduction

Affected by the global economic slowdown, international trade frictions and external macro-environmental shocks, Chinese enterprises are facing severe financing pressure and challenges in structural adjustment. To alleviate the financial difficulties and maintain their corporate image, some management teams have taken

desperate measures, using earnings management to embellish the financial statements in an attempt to convey false and favorable financial signals to external investors and creditors.

In this context, the phenomenon of “high deposits and high loans” - where enterprises hold a large amount of cash on their books while simultaneously bearing high interest-bearing debts - occurs frequently, drawing widespread attention from regulatory authorities and investors. Logically, a large amount of cash should be sufficient to repay due debts. However, in practice, enterprises such as Kangmei Pharmaceutical, Kangdexin, and Dongxue Optoelectronics have all fallen into crisis due to “high deposits and high loans” and the underlying financial fraud, even causing stock price collapses. For instance, Dongfang Group had 3.179 billion yuan in cash at the end of 2023, but its short-term loans reached 13.3 billion yuan; the regulatory report indicated that its revenue increased by 11.63% in 2020 but its net profit plummeted by 58.8% [1]. Eventually, it was confirmed that there were issues such as cash flow fraud and external auditing negligence. This indicates that “high deposits and high loans” are often closely related to management's attempts to conceal financial crises and pursue financing goals, and are deeply influenced by factors such as financing constraints and reliance on equity financing.

Against this grim backdrop, firms facing high external financing frictions or severe agency problems usually suffer from impaired investment efficiency, which may induce managers to adopt earnings management to mitigate crises or fulfil certain objectives [2]. Based on this, this paper aims to deeply explore the influence mechanism and transmission path of the “high deposit and high loan” anomaly on the earnings management behavior of enterprises from the dual perspectives of financing constraints and reliance on equity financing.

This paper mainly employs literature review and case-study analysis to systematically review the classic and cutting-edge literature on “high deposit and loan ratios”, financing constraints, equity structure, and earnings management both domestically and internationally. It also conducts in-depth analysis by combining typical practical cases such as Dongfang Group and Kangdexin. Its theoretical value lies in overcoming the limitations of prior standalone financial analyses, integrating macro financing constraints and equity financing dependence into a unified analytical framework, and enriching and expanding the theoretical research in the field of financial anomalies and earnings management. Practical significance: It reveals the true financial motives and risk causes behind “high deposit and loan”, provides practical references for investors to identify financial fraud and capital traps of listed companies. It also provides a decision-making basis for regulatory authorities to implement precise supervision, prevent systemic financial risks, and promote enterprises to optimize capital allocation efficiency.

2. The Phenomenon of High Deposits and High Loans

“High deposit and loan ratio” refers to a situation where an enterprise has a large amount of deposits on its books while also having a significant amount of loans. The balance sheet of such enterprises typically shows that the proportion of monetary funds in the deposits exceeds 25%, and the interest income does not match the deposits shown on the balance sheet. Most of the literature related to “high deposit and loan ratio” explores its impact on the financial behavior of enterprises from the perspective of causes. The monetary funds are scattered among different accounts of the enterprise, lacking unified allocation, causing the enterprise's deposits and loans to be at a high ratio simultaneously. This leads to the appearance of the “high deposit and loan” anomaly in the enterprise's financial statements. In addition, intense market competition and long collection cycles make it very easy for enterprises to have “high deposit and loan ratio” when they need to purchase raw materials while retaining deposits. Moreover, most enterprise shareholders in China often use transitional deposits and bill operations to beautify balance sheets and convey a good signal to investors. These anomalies used to beautify the balance sheets are often referred to as the reasons for the existence of the “high deposit and loan ratio” anomaly in enterprises.

The problems revealed behind “high deposit and loan” enterprises usually include low efficiency in using funds, false deposits, restricted access to funds, and a significant increase in enterprise risks [3]. While paying high interest on loans, a large number of low-interest deposits are forgotten, and the fund allocation is extremely unreasonable. The proper business operations and financial arrangements, as well as potential risks, contribute to the occurrence of this phenomenon. Enterprises engage in cashing out financial management, respond to industry cycles, and due to the characteristics of industries such as construction, the proportion of

funds is relatively high. The 'high deposit and loan' is also likely to be a signal of financial fraud by enterprises and the occupation of funds. Recent studies have further found that 'high deposit and loan' enterprises may manipulate their book cash through accounting fraud, temporary borrowing of funds at the end of the period, 'loan-to-deposit conversion', and repeated pledging of loans, in order to cover up the real financial pressure of the enterprise [4].

3. The Definition and Motivations of Earnings Management

Earnings management refers to the behavior of an enterprise's management team, based on compliance with accounting standards, to control and adjust the accounting profit information presented in the reports, in order to maximize the interests of the entity itself. From the perspective of the theory of information asymmetry, the management team possesses more internal information than external investors. This information advantage gives them the opportunity to use earnings management to conceal the true operating conditions or financial risks of the enterprise. When an enterprise has a large amount of monetary funds but also incurs high-interest debts, this seemingly contradictory "high deposit and high loan" financial situation is likely to trigger doubts from the outside about the authenticity of its funds and the rationality of its debts, which may provide an opportunity for the management team to implement earnings management. The management team, within the scope permitted by accounting standards, uses means such as the selection and application of accounting policies and accounting estimates, as well as the planning and arrangement of transaction matters, to artificially adjust the surplus information in the enterprise's financial reports to achieve specific purposes. Their motives are usually complex, possibly to meet the expectations of the capital market for the enterprise's performance, obtain financing convenience, or avoid regulatory requirements. It may also be related to the management team's personal interests such as salary incentives and promotion. Existing studies have shown that there is a close relationship between financing constraints and the behavior of earnings management. Financing constraints not only affect the financing decisions of the enterprise but also change the tendency of the management team to choose accrual earnings management or real earnings management [5]. Management may be more inclined to adjust earnings to explain or cover the possible problems behind the "high deposit and high loan" situation, such as funds being occupied or fictitious monetary funds, in order to make earnings management more likely and concealed in this context. Nowadays, management uses real earnings management far more than accrual earnings management because it is more common and concealed. Earnings management also integrates with digital technology. Earnings management refers to the behavior of an enterprise's management team, based on compliance with accounting standards, to control and adjust the accounting profit information presented in the reports, in order to maximize the interests of the entity itself. The use of visualization and other means significantly reduces the accounting operational space of the management team. The introduction of digital technology is reshaping the business model, internal control processes, and research paradigms of enterprises in an all-round way, promoting financial supervision towards multidisciplinary integration and intelligence [6].

4. The Relationship of "High Savings and High Loans" and Earnings Management

4.1 The Impact Mechanism of High Deposit and Loan Levels from the Perspective of Financing Constraints on Earnings Management

Currently, many Chinese listed companies restructured from state-owned enterprises feature concentrated ownership structures, under which shareholders or actual controllers exert substantial interference over corporate operational decisions. Under the "high deposit and loan" anomaly, the management of such enterprises may be more susceptible to the will of the controlling shareholder. To achieve specific equity financing goals or meet the demand for monetary funds under financing constraints, the major shareholders tend to use earnings management to embellish the financial statements. On the one hand, higher financing constraints bring greater difficulties and higher costs to enterprises' external financing. When financial pressure and the financial situation of the "high deposit and loan" anomaly hit the enterprise, the management may adjust the timing of revenue recognition, change the asset impairment provision policy, etc., to inflate profits and embellish the financial statements. The purpose is to convey to creditors or potential investors that the enterprise still has strong profitability, thereby attempting to alleviate the financing constraints. On the other hand, for enterprises with a high reliance on equity financing, they have a higher attention and sensitivity to

the capital market. To improve indicators such as the growth rate of net profit, the management of these enterprises often has a stronger motivation to choose earnings management to ensure the smooth implementation of the equity financing plan.

Among them, financing constraints and reliance on equity financing are regarded as important moderating factors. Financing constraints refer to the situation where the cost of external financing is higher than that of internal financing, and equity financing is difficult, with the cost of funds being much higher than that of non-financing-constrained enterprises, thereby affecting their own investment. Under the influence of financing constraints, it becomes more difficult for enterprises to obtain equity financing, and the required cost of capital is much higher than that of non-financing-constrained enterprises. In summary, the more severe the financing constraints are, the more tense the enterprise's capital chain becomes, and the “high deposit and high loan” phenomenon occurs frequently. Enterprises tend to choose to alleviate the crisis through earnings management means. Thus, it can be seen that financing constraints are one of the reasons affecting the “high deposit and high loan” phenomenon.

4.2 The Impact Mechanism of High Deposits and High Loans on Earnings Management from the Perspective of Equity-Financing Dependence

From the above, it can be seen that apart from financing constraints, in the perspective of equity dependence, “high deposit and loan” enterprises exhibit more prominent earnings management. Equity dependence refers to the situation where the majority of company shareholders have a high and one-way dependence on equity assets, structures, or financing. The actual controller holds a dominant position in the enterprise, and the high concentration of equity is one of the important means for the enterprise to obtain long-term assets.

Furthermore, external regulation in the capital market and the attention of intermediaries are equally important. For instance, securities analysts have a governance effect on corporate earnings management, influencing the strength of the correlation between “high deposits and high loans” and earnings management [7]. Similarly, the ESG performance of enterprises and the level of green innovation are also becoming key variables that affect financing constraints and enterprise value [8].

This forms a stable logical relationship chain where financing constraints and equity dependence jointly lead to high deposit and loan ratios, which further induce corporate earnings management. The Eastern Group is a typical case where it was forced to adopt the combination of “high deposit and loan ratios” and earnings management due to financing constraints, and this case effectively demonstrated the aforementioned relationship chain. Under the long-term operation of the enterprise, the gross profit of the main business was extremely low, and it suffered consecutive losses. The 1.64 billion in frozen funds accounted for 66.55% of the company's monetary funds. This clearly indicates a high rate of asset restrictions and blocked cash flow. At this time, it was difficult for banks to issue bonds, so the company had to borrow at high interest rates for financing, which was also an important factor contributing to earnings management. In the face of this crisis, the controlling shareholder, Zhang Hongwei, absolutely controlled the Eastern Group. He continuously occupied and misappropriated monetary funds and carried out large-scale fictitious financing trade in agricultural products. This led to the Eastern Group having extremely high fictitious increases in revenue and costs during the period from 2020 to 2023. The enterprise chose to use earnings management methods to cover up the breakage of the enterprise's capital chain and the exposure of financial fraud, and ultimately was forced to delist. This fully proves that from the perspective of financing constraints and equity dependence, “high deposit and loan ratios” have a significant impact on the enterprise's earnings management.

5. Conclusion

This paper conducts a systematic review of the research on “high deposit and high loan” and corporate earnings management from the perspectives of financing constraints and equity financing dependence. The following core conclusions are drawn: First, “high deposit and high loan” is a special financial anomaly resulting from the interweaving of multiple factors. This phenomenon is essentially a management issue triggered by internal governance flaws, external financing constraints, and equity structure characteristics, featuring both restricted monetary funds and high potential financial risks. Second, the financing motive significantly strengthens the tendency of corporate earnings management. Earnings management is based on the theory of principal-agent and information asymmetry. Under financing pressure, both external financing

constraints and equity financing dependence will significantly enhance the management motivation of the top management to adjust accounting profits to cover up financial statements and conceal financial crises in order to obtain loans. Third, there are dual transmission paths and practical cases to support this. On one hand, under the financing constraint path, enterprises are forced to form “high deposit and high loan” due to tight capital chains and attempt to cover up financial crises through earnings management to obtain loans. On the other hand, under the equity financing dependence path, enterprises deliberately create the illusion of “high deposit and high loan” to meet the regulatory requirements of the capital market for refinancing, thereby triggering more concealed earnings management behaviors. Cases such as Kangdixin and Dongfang Group fully confirm the existence of the above-mentioned influence mechanism. Fourth, the current research still has certain limitations. Currently, the literature is mostly based on empirical and case analysis, but there is still a need for further deepening in aspects such as the definition standard of “high deposit and high loan” indicators, the differences in the effect under heterogeneous environments, and the comprehensive influence mechanism under the interweaving of multiple factors.

This research holds significant theoretical and practical value. From a theoretical perspective, this paper integrates the research on the relationship between “high deposit and high loan” and earnings management under the perspectives of financing constraints and equity financing dependence, filling the gaps and deficiencies in existing research perspectives and enriching the theoretical system of financial anomalies and earnings management. From a practical perspective, it reveals the intrinsic motivation of earnings management in enterprises with “high deposit and high loan” characteristics, providing theoretical references for investors to identify financial risks of enterprises, regulatory authorities to formulate targeted regulatory methods and preventive measures, enterprises to optimize capital allocation and governance structure, and helping to prevent financial abnormal risks of listed companies.

In light of the limitations of the existing research, future work can be further developed in the following three specific dimensions: Firstly, optimize the quantification and measurement accuracy of indicators, rely on the notes to the financial statements to distinguish between pledged funds, margin funds, and frozen funds, and construct the “actual available monetary funds” indicator to accurately identify false high deposits. Quantify the inverted difference between “interest income rate and expenditure rate”, and set dynamic thresholds based on industry characteristics to avoid “one-size-fits-all” indicators. Secondly, deepen the micro governance mechanism and context exploration, deeply investigate the equity pledge rate, capital occupation, and control rights separation degree, and reveal the path by which shareholders use “high deposit and high loan” to conceal illegal activities. Thirdly, innovate research methods and practical implementation, use text mining to extract soft information from inquiry letters and notes, combine the double difference method or machine learning algorithms, and construct an early warning model for financial fraud involving “high deposit and high loan”. Promote the regulatory authorities to establish a special disclosure and inquiry mechanism for large deposits, broaden the direct financing channels of enterprises, and fundamentally alleviate the motivation for fraud caused by financing constraints.

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Conflicts of Interest

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