FIRM CHARACTERISTICS AND EARNINGS MANAGEMENT USING CLASSIFICATION SHIFTING

Pawan Jain, Institute of Management Technology
Hanish Rajpal, Goa Institute of Management

ABSTRACT

Prior literature has shown that there are three major strategies of Earning Management Accrual-based earnings management (AEM), Real earnings management (REM) and Classification shifting. The study introduces various earning management techniques and build up a conceptual framework on the basis of past literature available The paper tries to examine various firms' characteristics and firms' possible adoption of any of these Earning Management techniques in general and classification shifting in specific. The paper also tries to examine the level of adoption of these techniques by the firms. We find that adoption and level of adoption of Earning Management techniques depend on multiple factors. While AEM and REM adoption pose a risk of being discovered at a later date or deferring of expenses required for smooth running of business, classification shifting is merely shifting of numbers where auditors/analysts may not have sufficient motivation to question managers on this number shifting. Hence we concluded that Classification shifting is presenting itself to be a less costly, less hassle free, less technical and less to be discovered earning management technique by the Firms world over.

Keywords: Earning Management, Classification Shifting, Firms Characteristics.

INTRODUCTION

At the beginning of 21st Century, the world witnessed multiple corporate scandals in USA & Europe causing loss of billions of US dollars in valuation of companies, wide fluctuations in stock exchanges across the globe, closing down of many large business houses and loss of investors' confidence. It was found that core issue behind this misrepresentation of accounting numbers is Earning Management. Firms across the globe used earning management as a tool for misrepresentation of financial numbers, deferring of revenue, shifting of expenses, false presentation of core earnings etc. Earning Management as *"earning management occurs when Managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers"*. Researchers have so far found out three ways of Earning Management adopted by firms globally-Accrual-based earnings management (AEM) aims to manipulate true economic performance by changing accounting methods or estimates within the generally accepted accounting principle while Real earnings management (REM) alters the execution of real business transactions. Few researches provided that management may resort to accounting choices that increase Income to conceal poor performance. Which is the third approach to Earning Management, a less researched approach, also known as Classification Shifting. Thus, construct of earnings management using classification shifting is based on the premise that firms may classify core expenses as special items or may classify non-operating revenue as operating revenue in order to inflate the core earnings. Classification shifting is one of the strategy of Earning Management

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where Managers move items within Statement of Profit & Loss to improve core earnings. Managers may be motivated to do so as market participants are more interested in core earnings than the bottom line (Bradshaw & Sloan, 2002; Gu & Chen, 2004). Classification shifting involves reporting revenues, expenses, gains, and losses on different lines on the income statement other than those on which they should properly appear under GAAP.

There have been multiple incentives for firms to adopt classification shifting as a tool of earning management. Barua et al. (2010) are of the opinion that Managers could engage in this form of earnings management if they perceive that investors value recurring earnings more than nonrecurring earnings. It is difficult for investors to detect this type of earnings management because discontinued operations are not usually disclosed in detail in the financial statements. Unlike other forms of earnings management, such as accrual management or real activity manipulation, classification shifting does not change net income and may be a less costly form of earning management. Managers achieve classification shifting by allocating operating expenses to discontinued operations. By allocating operating expenses to discontinued operations, managers can increase operating income, income from continued operations and core earnings. Increase in all three results in higher stock valuation. As there is no detailed disclosure about discontinued operations in financial statements, this leads to information asymmetry between managers and investors as investors are not aware of numbers allocated to discontinued operations. They further conclude that it is easier to shift operating expenses to discontinued operation as world over, researchers' attention is majorly on special items and discontinued operations is still not being researched thoroughly as special items.

The market overvalues the core earnings of firms that engage in income classification shifting *"classification shifters"*. They observed that It is likely that earnings management using classification tactics is not easily detected and accordingly, significant resource allocation inefficiencies (e.g., mispricing of earnings) are likely to exist.

Further, Classification shifting has multiple advantages over AEM and REM. Classification shifting is more difficult to detect than AEM or REM. In classification shifting, when regular operating expenses are shifted to non-recurring expenses or to discontinued operations, total amount of expenses and income remains same or the shifting may increase core earnings or pretax earnings. This draws less attention from the auditors, public and other agencies. Also, due to subjectivity in standards dealing with classification of expenses, auditors have limited argumentive power or motivation to seek clarification on classification shifting from Management. Moreover, Classification shifting is an accounting manipulation as against AEM and REM where managers have to defer actual operational transactions. Due to this, Classification shifting has lower cost of detection. Since Classification shifting has lesser probability of detection compared to AEM and REM and less costly to implement, it presents itself as a viable and superior alternative to other Earning Management techniques–AEM & REM (Richardson et al., 2002).

The firms missing their year-end earnings forecast and engaged in R&D classification shifting make more R&D narratives in their fourth quarter relative to the third quarter conference calls. They claimed that managers engage in R&D classification shifting once they realize that earnings targets cannot be met and use R&D expense as a justification for missing earnings benchmark.

Abernathy proposes that out of the 3 techniques available for achieving earning management–AEM, REM and classification shifting, Firms choose classification shifting as an alternative to AEM & REM under influence of multiple factors. They argued that when firms are

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constrained by poor financial condition, high levels of institutional ownership and low industry market share, they are more likely to choose classification shifting. Further, if firms are constrained by low accounting system flexibility and the provision of a cash flow forecast, managers are more likely to use classification shifting.

McVay (2006) very first time presents the empirical evidence of classification shifting of core expenses to special items such that as the unexpected core earnings increases, the income decreasing special items also increase leading to a positive relationship between unexpected core earnings and special items. In similar vein, Malikov et al. (2018) presents the evidence of firms classifying non-operating revenue as operating revenue such that as the unexpected operating revenue increases, non-operating revenue decreases leading to a negative relationship between unexpected operating revenue and non-operating revenue. They further concluded that classification shifting of revenue is more pervasive for firms that report operating loss or have low growth.

This paper examines how firm characteristics such as financial health, Ownership, tax rates, size, performance, leverage etc. affect adoption of Classification shifting by Firms as method of Earning Management. The objective of this paper is to comment on firms' using Classification shifting as an alternate to other earning management technique –REM & AEM. The paper is qualitative in nature. The paper is divided in following sections –Section I is Introduction. Section II covers literature review. Section III deals with conceptual framework. Section IV describe firm characteristics and their effect on adoption of classification shifting by firms as method of earning management. Section V is Conclusion.

LITERATURE REVIEW

The motivations for managers to manage earnings. The managerial motivations include stock market incentives such as earnings management before IPOs and SEOs (Nikbakht et al., 2021; Aharony et al., 2010; Shen et al., 2014; Cohen & Zarowin, 2010). Earnings management before management buyouts (Fischer & Louis, 2008; Francis et al., 2016), earnings management to influence analyst forecasts (Dhaliwal et al., 2004; Matsumoto, 2002; Bartov, 1993; Lim, 2001). In addition, prior studies have also documented that management may have incentives for higher earnings management in case the firm has higher debt while lenders may exert control over the firm leading to reduction in overall earnings management (Givoly et al., 2010; Rodríguez-Pérez & Van Hemmen, 2010; An et al., 2016; Liu et al., 2010). Further, compensation contracts may influence earnings management. For example the managers may manage earnings to influence bonus payouts or stock option contracts (Guidry et al., 1999; Shuto, 2007; Ibrahim & Lloyd, 2011; Eckles et al., 2011; Cohen et al., 2008; Zhang et al., 2008).

Nagar & Sen (2017) were of the opinion that Managers of financially distressed firms are more likely to inflate core or operating income as compared to the healthy firms to meet or beat earnings benchmarks through classification shifting.

Nagar & Sen (2017) came out with another incentive for Earning Management through Classification shifting. They suggested that firms in the decline stage of lifecycle are more likely to use classification shifting to avoid reporting of operating losses.

The companies strategically use both revenues and expenses to manage core earnings at the time of transition period (transition from domestics Accounting principles to IFRS) by shifting other income as a common tactic to improve their operating performance and special expenses just to meet or beat earnings targets.

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Most of the prior studies have considered either accrual based or real earnings management while testing motivations for earnings management and investigating firm characteristics. We believe that the method of earnings management may vary depending upon the motivation of managing earnings and the firm characteristics. This study explores the characteristics of firms indulging in earnings management using classification shifting and how these characteristics affect adoption of classification shifting as an earning management tool by Firms (Rodríguez-Pérez & Van Hemmen, 2010).

CONCEPTUAL FRAMEWORK

Earning Management as earning management occurs when Managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. The purpose of Earning Management is to take some benefits either in terms of presenting good financial numbers when firm is not doing well or at the time of raising funds when showing better financial health will give firm the access to cheaper cost of funds. Earning management is adopted by Firms world over to meet analysts/stock market expectations.

Earning Management is carried out through methods like Accrual based Earning Management (AEM), Real Earning Management and Earning Management through Classification shifting.

Accrual based Earning Management (AEM) is where managers changes the accrual pattern. They do so by applying their judgement on various estimates & provisioning. AEM is generally done at the end of financial year which can be easily explored by Auditors. Also, the method may be costly in terms of reversal of estimations & provisioning in future period causing Firms to face loss of shareholders' wealth. Since the accruals can be easily explored, managers may find it difficult to justify the wrong estimations and provisioning and lose their credibility.

Real Earning Management (REM) is achieved by Managers by changing timing and structure of business decisions. Changing investment in R&D, reducing prices at the end of financial year, shifting required investment etc are some of the examples of REM. These decisions could look simple business decisions to an outsiders yet they are nothing but a tool for managing earning. Auditors & Shareholders find it more difficult to detect REM as these are presented as simple business decisions. Merely changing timings of Operating, Financial & Investing activities may not attract much of the attention and hence REM detection is not an easy task. However, REM is as costly in terms of delaying investment decisions or increasing price discounts results in wrong business decisions causing loss in shareholders wealth. Adoption of REM may also result in closure of firms due to excessive cash out flows & concealment of true view of financial statements.

Classification shifting is another way of Earning Management which is being used by Managers world over to manage earnings of the firm. McVay (2006) defines Classification shifting as an earning management strategy whereby managers move items within the income statement to improve core earnings. Managers shift core expenses to one time or special items, other revenues are shifted to core revenue, one time revenue are taken as other revenue etc. The objective is to boost the core earning of the firm as managers assume and research have also shown that market give weightage to Core Earning numbers. Unlike AEM where change of numbers in future or REM where deferring business decisions may result in loss of shareholders wealth, Classification shifting has low level of such risk. Auditors & shareholders find

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classification shifting difficult to detect. In comparison to AEM & REM, classification shifting has low economic cost if detected. Managers adopting classification shifting work on the assumption that analysts/shareholders may not be aware of exact classification or nature of expenses/revenue items being shifted and as such have low risk of detection. Further, classification shifting is a low cost Earning Management strategy and there is not much incentive for analysts/auditors for detection of the same (Baxter & Cotter, 2009).

Quite often, Managers use more than one Earning Management strategy to shift attention of auditors & analysts. Since Classification shifting is merely accounting numbers shifting and does not cost too much for the firms, managers can hide classification shifting while using this technique with AEM or REM.

With this conceptual framework, in next section, we discuss various firms' characteristics and how these characteristics affect adoption of Earning Management strategies.

FIRM CHARACTERISTICS AND THEIR EFFECT ON ADOPTION OF CLASSIFICATION SHIFTING

Classification shifting is adopted by Managers across the globe as an Earning Management strategy. There are multiple firm characteristics which have linkage with adoption of Classification Shifting as an Earning Management technique. Likelihood of adoption of classification shifting varies with the presence of these firm characteristics (Dechow et al., 1996).

Presence of Higher Tax Rates in Economy

In any economy where there is presence of higher tax rates, classification shifting is preferred over other Earning Management techniques like AEM or REM. For instance, when a manager defer or reduce expenses, there is an increase in taxable profit which attract higher tax liability. However, in case of classification shifting, the focus is on core earning numbers only. When managers adopt classification shifting as Earning Management strategy, it is only the movement of financial numbers leaving no or little impact on net taxable income. This does not result in any additional tax liability. Thus, there is high probability that firms which are in high tax rates economy tend to adopt Classification Shifting as Earning Management strategy.

Financial Health

Across the globe, Firms face many phases of growth & downfall. Some firms grow at extraordinary rates while other firms face a severe downfall due to multiple reasons. The firms which are growing would like to continue the success story. Some firms which may foresee problem times ahead may shift timings and pattern of revenue & expenses. These firms may prefer AEM over other Earning Management strategies. Firms which are facing troubled times will prefer survival & improvement in operational activities over financial reporting. These firms may not adopt any Earning Management technique due to–i) These firms have already poor financial numbers. Shifting these numbers may not affect Financial Statements much. ii.) Adopting REM and/or AEM may prove fatal for these firms as market may not take these manipulated numbers in a good taste. Thus, there is less likelihood that companies with poor financial health will choose any Earning Management strategy.

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Ownership Pattern

Firms have promoter owners and institutional owners as well. Many firms have their sufficient shareholding with Institutional Shareholders. These Institutional investors can be mutual funds, insurance companies, foreign institutional investors, hedge funds, equity funds etc. These Investors have extensive understanding of financial numbers, knowledge of the industry & company and if any firm attempts to go for AEM or REM, institutional ownership work as a deterrent for the same. These Institutional Investors monitor financial numbers regularly and work closely with Auditors/Analysts. Classification shifting, however may not attract that keen observation from these Institutional Investors yet Firms, on their own do not attempt to go for classification as *"someone is watching"*. Hence presence of institutional ownership ensure comparatively lower level of adoption of classification shifting or any other earning management technology. Furthermore, high presence of retail investors in shareholding pattern may also attract managers to go for classification shifting.

Market Share

Firms generally adopt REM/AEM as Earning Management techniques. By doing so, these firms deviate from operational efficiency and rather work on manipulating financial numbers. This can be risky as rather than enhancing operational efficiency, they are changing accruals pattern, manipulating numbers etc. This way they may loose their market share and customers. Thus, firms with intense competition and good market share may shy away from AEM/REM and if needed will go for Classification shifting as earning management strategy. Similarly, firms with low market share will run the risk of losing their already dwindling standing in market if they adopt AEM/REM and which is exposed by auditors & analysts. Therefore firms with low market share also look for Classification shifting as Earning Management strategy (Rajgopal et al., 1999).

Audit Firms & Audit Patterns

When a firm has hired audit firms of repute and where audit tenure is for a longer period, the firm does not resort to AEM/REM as earning management strategy. The audit firm if hired for a longer period in continuation will understand the business and also financial statement number placements. This will work as a deterrent for the firms to adopt any type of Earning Management strategy.

Financial Reporting System

Firms adopt financial reporting system to report their financial numbers. Firms with no or less flexibility in reporting system may not adopt AEM/REM as reporting system will not allow shifting of accruals or other methods of AEM/REM. In such cases, firms look for other earning management strategy and classification shifting turns out to be viable and less costly technique. Thus firms with no or less flexibility in their financial reporting system have more likelihood of adopting Classification shifting.

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Strong Investor Protection Regulations

In the economies where there are strong investor protection regulations, firms avoid using AEM/REM as any disclosure related with firm using these techniques will be severely penalized. Strong Investor Protection regulations work as a constraint for AEM/REM. In such instances, firms avoid using any type of Earning Management technique. Even if classification shifting is found out by auditors and reported to authorities, such instance may be dealt with severely.

Intermittent Period during Shifting from one Reporting Standard Body to other

In year 2002, when European Union adopted IFRS, there was a period when countries were shifted from their respective reporting standards to IFRS. This period was utilized by many firms for earning management. Firms were able to do so as rules & commentaries were being prepared for various reporting standards and clarity on many issues were missing, some countries were following rule based reporting standards and then shifted to principle based reporting standards, reconciliations rules were inadequate etc. These reasons gave companies ample opportunities to go for adoption of AEM/REM. Classification shifting was in its nascent stage. Thus this period was utilized by firms for financial number manipulation using AEM/REM as earning management strategies (Ajit et al., 2013).

Pressure to Meet Analysts Forecast

Across the Globe and developed economies in specific, shareholders and other interested parties give substantial weightage to analysts' forecasts. Firms not meeting these forecasts are penalized by market in the form of fall in their share prices, squeeze in flow of capital to such firms, increased fund costs etc. Firms in such economies try to present financial numbers which are not only meeting analysts' forecasts but also presenting a good financial position in front of its readers. Due to such pressure, there is great likelihood that firms may adopt earning management techniques if they are not able to achieve forecasted numbers. However, which strategy is to be adopted depends upon various other factors which have already been discussed in this paper. Since analysts pressurize firms to present a good core earning numbers, classification shifting becomes a favourite strategy for the firms as AEM/REM can be discovered by analysts/auditors. Thus, firms which are under pressure to meet analysts forecast may adopt classification shifting as earning management strategy.

Thus, over last decade, classification shifting has come out as a viable and less costly alternate to other earning management techniques, AEM and/or REM. Firms may adopt classification shifting depending firms' characteristics as defined above amounts (SEC, 2000).

CONCLUSION

The literature available so far has brought out 3 different types of Earning Management techniques which are adopted by the firm's world over, AEM, REM and classification shifting. This paper has tried to investigate various firms' characteristics and how these characteristics impact the adoption of any or all of these earning management techniques. The paper concludes that firms all over the world adopt one or the other earning management technique. However, prior literature has shown that adoption of classification shifting is gaining momentum among managers as the method is less costly, does not leave a permanent change in financial numbers,

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auditors & analysts have less motivation to investigate managers and dig out information and market may not react so sharply if any such number shifting is discovered. Paper has explored with prior literature, varied degree of adoption of classification shifting by the firms. However, no empirical research method or data analysis technique has been used here. Costs & constraints in adoption of classification shifting has not been investigated which requires further research. Classification shifting is becoming a matter of concern for financial reporting regulators world over. Securities and Exchange Commission (SEC) states, the appropriate classification of amounts within the income statement is as important as the appropriate measurement or recognition of such amounts.

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