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Managing earnings using classification shifting: UK evidence

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A R T I C L E I N F O

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A B S T R A C T

This study examines whether UK companies engage in classification shifting in the post IFRS era. While IFRS were issued to improve the quality of accounting practices and provide users with more useful information, non-recurring items disclosure is less regulated than under UK GAAP. Therefore, firms have more opportunity to exercise discretion in the classification of items within the Income Statement. Whilst there is only weak evidence of misclassification of recurring items prior to the introduction of IFRS (Athanasakou et al., 2009), our results reveal that managers are more likely to exercise their discretion in the disclosure of non-recurring items following the adoption of IFRS. More specifically, it is found that managers are more likely to misclassify some recurring items as non-recurring when this allows them to report core earnings increases. In contrast, there is no evidence that companies engage in classification shifting to avoid reporting core losses. However, this may be logical behaviour in that, while credit rating agencies do not penalize firms who use classification shifting to avoid reporting core earnings decreases, they may penalize firms who use it to avoid reporting core losses.

1. Introduction

The objectives of this study are twofold. First, to examine the misclassification of recurring items as non-recurring or exceptional items (Classification Shifting) by UK firms. Second, to provide evidence on how credit rating agencies interpret such behaviour. The bulk of prior studies on earnings management have focused on either accruals or real earnings management. Little evidence on classification shifting is available, especially in the post-IFRS era. In contrast to previous UK GAAP, which was relatively prescriptive regarding the treatment and disclosure of non-recurring items under FRS3[1] (ASB, 1992), IFRS is relatively silent regarding this issue. IAS1 requires presentation of additional line items, headings or subtotals when such information is relevant to understanding the entity's financial position, taking into account its materiality and the nature and function of the items of income and expense. Indeed, IAS1 does not prohibit firms from disclosing as many subtotals as they wish, including earnings before non-recurring items, and companies have considerably more scope under IFRS to report various non-GAAP measures of income.

Companies contend that they use this discretion to provide information useful for improving investors' understanding of their profitability, and to remove potentially confusing volatility in reported earnings. For example, Cobham Company in its 2009 annual report stated that:

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[1] FRS3 required companies to separately disclose after operating profit and before interest, any profits or losses on sale or termination of operations, costs of fundamental reorganisations and profits or losses on disposal of Noncurrent Assets. All other exceptional items had to be included under the relevant statutory format headings and disclosed by way of note or on the face of the statement. Each item was to be described to ensure its nature may be understood.

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"In addition to the information required by IFRS and to assist with the understanding of earnings trends, the Group has included within its published statements trading profit and underlying earnings results"

J Sainsbury plc in its 2010 annual report similarly stated that:

Certain items recognized in reported profit before tax can vary significantly from year to year and therefore create volatility in reported earnings which does not reflect the Group's underlying performance. The Directors believe that the 'underlying profit before tax' ("UPBT") and 'underlying diluted and basic earnings per share' measures presented provide a clear and consistent presentation of the underlying performance of Sainsbury's ongoing business for shareholders

While Millenium Hotels, 2009, stated that:

In presenting the Group's profitability, headline operating profit, headline EBITDA, headline profit before tax, headline profit after tax and headline earnings per share are calculated. …. The Group believes that it is both useful and necessary to report these measures for the following reasons:

- *they are measures used by the Group for internal performance analysis; and*
- *they are useful in connection with discussions with the investment analyst community.*

While the desire to provide more meaningful information may be a motive, such disclosures may instead seek to mislead investors. The greater flexibility under IAS1, coupled with relatively higher scrutiny of accruals-based earnings management, might provide incentives for the misclassification of recurring expenses as non-recurring within the income statement in order to report more favourable core earnings[2] and underlying or persistent profitability.

How UK firms treat non-recurring items in the absence of detailed guidance by the IASB remains an open question. This is an important research question because of the debate between IASB and FASB regarding the treatment of non-recurring items. Our results provide evidence on the validity of the arguments put forward by FASB and IASB. More specifically, while FASB and IASB chose not to address non-recurring items under their conversion project, they had significantly different views on the importance of a standard in this area. In their discussion paper "Preliminary Views on Financial Statement Presentation" (IASB, 2008), the FASB opinion was that each entity should disclose information about unusual or infrequent events or transactions to improve users' understanding about components within a line item that are less persistent and more subjective. In contrast, the IASB did not support this view because there is no notion of unusual or infrequent events or transactions in IFRSs.[3]

Existing research on earnings management has focused mainly on equity markets. There is a lack of evidence over the use of published financial information in debt markets and, in particular, how this might affect firms' attitudes towards classification shifting. Whilst extant studies have investigated how investors react to published information, this analysis cannot be complete without an investigation of debt markets. From a standard setters' perspective, the purpose of financial statements in general and earnings in particular is to serve the decision making needs of all stakeholders (Callen, Livnat, & Segal, 2009). Therefore, it is worth investigating whether the debt market has a different behaviour towards accounting information. Some of the key players in the debt markets are credit rating agencies. Their ratings are seen as efficient benchmarks for default risk and therefore the cost of debt is determined based on their rating information (Frost, 2007). Arguably, credit rating agencies have an information advantage regarding firms' prospects. They are also more sophisticated and potentially less likely to rely on published information to assign their ratings. For example, credit rating agencies have access to unpublished information such as board meeting minutes, internal capital allocations, and breakdown of profit by product (Ederington & Yawitz, 1987; Jiang, 2008). Accordingly, it is an open empirical question whether credit rating agencies are attentive to published accounting information and use earnings benchmarks in assigning their ratings. If they do, it might provide evidence on a new motivation for firms to beat core earnings benchmarks.

The current study addresses the ongoing debate on whether credit rating agencies use accounting information. We investigate whether credit rating agencies utilise core earnings benchmarks in assigning their ratings by examining the relationship between credit rating change and earnings benchmarks. We also investigate whether credit rating agencies penalize firms that use classification shifting to achieve these benchmarks. Our analysis could provide evidence on a new deterrent of earnings management.

Using a sample of UK firms over the period 2008–2010, we investigate whether UK firms engage in classification shifting and whether credit rating agencies can see through this behaviour. The results show a significant positive relationship between non-recurring expenses and unexpected core earnings, providing evidence that UK firms consider classification shifting to be a viable manipulation method. We also find that classification shifting is more pervasive when it allows firms to avoid reporting a core earnings decrease. However, unlike prior accruals-based earnings management studies (e.g. Gore, Pope, & Singh, 2007), we find no evidence that classification shifting is more prevalent when it allows firms to avoid reporting a core loss. Our results suggest that this may be logical behaviour in that, while credit rating agencies significantly penalize or reduce their rating of firms who use classification shifting to avoid reporting core losses, they do not penalize firms who use it to avoid reporting core earnings decreases.

Our study makes several contributions to the earnings management literature. First, it adds to our understanding of financial

[2] Core earnings are also referred to as Pro-forma earnings and non-GAAP earnings and these terms may be used interchangeably to refer to earnings before non-recurring items.

[3] While this project resulted in a joint staff draft of a proposed standard, the project was paused in 2011.

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