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Classificatory income smoothing: The impact of a change in regime of reporting financial performance

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Abstract

Financial Reporting Standard No. 3 (FRS3) regulated the reporting of financial performance by UK firms from 1993 until the adoption of International Financial Reporting Standards in 2005. FRS3 outlawed extraordinary items, but allowed a clearer distinction between recurring and transitory income by giving firms discretion over the classifications of unusual (i.e. exceptional) items and the option to disclose alternative EPS. Through these provisions FRS3 increased the scope for classificatory choices as a means to highlight persistent profitability. We examine the impact of FRS3 on classificatory smoothing by UK firms and document a significant rise in this practice post-FRS3. We find that this increase is due mainly to deviations of net income from expected earnings inducing a significantly higher level of classificatory smoothing post-FRS3. Additional analysis shows that earnings are substantially more persistent at the pre-exceptional level post-FRS3. Overall, our results suggest greater use of classificatory choices to highlight sustainable profitability after the change in performance reporting regime.

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1. Introduction

In their current convergence project on financial statement presentation, the aim of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) is to establish a common standard for presentation of information in financial statements that improves the ability of investors to appraise current performance and forecast future profitability. The two boards have decided that financial statements should include a single statement of earnings and comprehensive income. They have also agreed on a set of presentation principles, but have yet to determine a common approach for disaggregating financial information and the totals and subtotals to report in the income statement (IASB, 2006). At the same time, US regulators are concerned about increasing investor reliance on adjusted earnings (e.g. pro forma or street earnings) disclosed in earnings announcements, as these disclosures give managers considerable discretion over which items to include or exclude from the alternative earnings definition. In the light of these current developments, we conduct a timely policy experiment on the potential effect of disaggregating income components and highlighting alternative measures of performance within the income statement. We explore the impact of Financial Reporting Standard No. 3 (FRS3): *Reporting Financial Performance* on the practice of income smoothing via classifications of transitory items as a way of highlighting recurrent profitability by UK firms.

The UK Accounting Standards Board issued FRS3 in 1992, changing radically how UK firms report financial performance. Before FRS3, SSAP3 required firms to report basic EPS on ordinary income after exceptional items and taxation, while SSAP6 offered a flexible definition of extraordinary items.[1] This encouraged inconsistent classifications of items below ordinary income and classificatory smoothing through extraordinary items. It raised concerns among UK authorities that companies were increasingly classifying transitory items as extraordinary mainly when they were expenses or losses, and as exceptional (above ordinary income) when they were revenue or profits. FRS3 effectively reclassified all extraordinary items as exceptional and mandated calculation of basic EPS on net income, thereby disabling classifications of

[1] FRS3 amended Statement of Standard Accounting Practice No. 3 (SSAP3), issued by the ASB's predecessor, the Accounting Standards Committee (ASC), and superseded SSAP6.