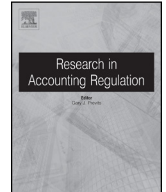
Research in Accounting Regulation 27 (2015) 1–13

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg



Regular Paper

Discretionary allocation of corporate income to segments

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ARTICLE INFO

Article history:
Available online 26 March 2015

JEL Codes:
M41

Keywords:
Segments
FAS 131
Proprietary costs
Agency costs
Mandatory disclosure
Earnings response coefficient

ABSTRACT

The SEC continues to view companies' segment disclosures, including segment earnings, as needing improvement. Under a controversial provision of FAS 131, the sum of a company's segment earnings need not equal corporate net income. We refer to the difference between summed segment earnings and corporate-level income, when it exists, as the Gap. This study examines why Gaps exist. We find that the existence and direction of Gaps appear to reflect both reporting decisions intended to better reflect segment operating results and reporting incentives to obscure differences in profitability across segments. Gaps created for the former reason are shown to provide useful information to investors. We also find that summed segment earnings are, on average, more useful than corporate earnings (i.e. more persistent, predictable and informative) when there are negative Gaps (aggregated segment earnings exceed comparable corporate earnings), but less useful, on average, when positive Gaps are observed. On balance the evidence suggests that the FASB's decision in FAS 131 to allow segment-related income Gaps was justified.

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Introduction

Segment reporting has long been of concern to U.S. regulators and investors. For example, segment reporting is one of the most common areas discussed in comment letters sent by the Securities and Exchange Commission (SEC) to companies with suspected disclosure deficiencies (Chasan, 2013). Firms' segment reporting practices have triggered SEC investigations.[1] Investors have raised questions about possible abuses of segment data.[2] We employ firms' segment reporting data to investigate a controversial aspect of Statement of Financial Accounting Standard No. 131 (FAS 131) guidance: the allocation of revenues and expenses to and among segments.[3]

FAS 131 allows companies to measure segment earnings differently than is required for the consolidated reporting entity. Thus, segment earnings can *exclude* expenses (or revenues) typically recognized under generally

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[1] For example, Trachtenberg (2013) reports that "The SEC also is looking into a former employee's allegations that Barnes & Noble had improperly allocated [certain expenses] between its Nook devices and ebooks business, and its consumer bookstore group in its earning reporting ..." This is an investigation of alleged improper allocation of expenses across segments, because Barnes & Noble's "Nook devices and ebooks business" is housed in its Nook segment, and its "consumer bookstore group" is housed in its B&N Retail segment.

[2] For example, during Groupon's IPO process in 2011, investors questioned its initial filings that reported "adjusted consolidated segment operating income". That version of earnings excluded from the company's operating income several major expenses, including marketing and acquisition-related costs (De La Merced, 2011).

[3] *Disclosures about Segments of an Enterprise and Related Information* (FAS 131, Financial Accounting Standards Board (FASB), 1997). FAS 131 is presented under FASB codification Section 280: Segment Reporting.

http://dx.doi.org/10.1016/j.racreg.2015.03.001
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accepted accounting principles, GAAP.[4] In addition, FAS 131 allows companies to *include* revenues (or expenses) in segment earnings that GAAP does not allow as elements of corporate net income.[5] Therefore the sum of segment earnings need not equal corporate net income, nor is it required to equal any corporate earnings subtotal, such as operating income (however defined). We refer to the difference between summed segment earnings and corporate-level income, when it exists, as incomplete allocation of corporate income, or as the Gap.

Opponents of the provisions of FAS 131 that enable Gaps argue that it provides managers with leeway to manipulate earnings information at the segment level. Proponents believe that the allocation or non-allocation of expenses or revenues reflects legitimate internal reporting decisions and can provide analysts and investors with a more meaningful view of segment performance. Absent evidence, it is not clear which of these views is correct, or whether both are true under certain conditions. Despite the controversy regarding non-GAAP segment earnings allowed under FAS 131, no published research has explored why some multi-segment companies disaggregate their corporate earnings less completely than others, and how incomplete allocation (i.e. Gaps) affects the usefulness of segment earnings. This paper addresses those issues.

A company's Gap equals comparable corporate earnings minus aggregated segment earnings.[6] A negative (positive) Gap exists when corporate earnings is less than (greater than) the sum of segment earnings. We define a dichotomous Gap variable as equal to 1 if a company exhibits a Gap, and equal to 0 otherwise. We also employ a variable consisting of the ranked absolute value of Gaps to measure the magnitude of Gaps. Using a sample of 20,594 company-year observations during 1998–2012, we investigate several factors that influence the magnitude of Gaps. Our results indicate that variables representing goodwill, other intangibles, merger and acquisition activity, and special income items, are significantly associated with the magnitude of Gaps. These results are consistent with a more positive view of Gaps – that firms appear to allocate components of corporate income to segments when the related activities are controlled by segment-level managers, and/or the income items persist. We find that companies operating in industries characterized by smaller numbers of powerful competitors and companies with inefficient cross-segment transfer of firm resources are likely to exhibit larger Gaps. We interpret these effects as attempts by managers to conceal information from their competitors and shareholders.

We also examine whether Gaps lead to more or less useful information for investors. The similarities between segment earnings with Gaps and *pro forma* versions of earnings, to be discussed later, suggest that the usefulness to investors of Gaps in aggregated segment earnings be assessed in the same way the usefulness of *pro forma* earnings have been assessed. Therefore we investigate the consequences of Gaps as they affect earnings persistence over 1-year periods, and as they affect earnings informativeness (association with annual market-adjusted buy-and-hold returns). We compare the persistence and informativeness for aggregated segment earnings and comparable corporate income.

We find different results for firms with negative Gaps versus positive Gaps. Aggregated segment earnings with negative Gaps resemble *pro forma* versions of income in which "transitory" or "non-core" expenses and losses are added back. Therefore we expect investors' responses to segment earnings with negative Gaps are similar to investors' responses to *pro forma* earnings. Our results generally agree with our expectations. We find that aggregated segment earnings characterized by negative Gaps are more persistent (predictable) than corporate income. In contrast, when firms have positive Gaps, corporate income tends to be more persistent than aggregated segment earnings. Result implications are similar when we test the association between earnings and concurrent stock returns. That is, for firms with negative Gaps, the association of returns with aggregated earnings is positive and significantly greater than the association with corporate income, and the explanatory power of aggregated earnings is significantly greater than that of corporate income. For firms with positive Gaps, the coefficient of corporate income is significantly greater than the coefficient of aggregated earnings. In summary, segment earnings are more persistent and informative than comparable corporate earnings when Gaps are negative, i.e. corporate expenses and losses that are likely transitory in nature are not pushed down to the segment level. On the other hand, when revenue and gains are not pushed down to the segment level, corporate earnings are more persistent and informative.

This study has implications for regulators and standard-setters, as well as contributing to the academic literature. Our findings address the debate related to allowing non-GAAP earnings to be reported at the segment level. Our results suggest that managers' allocation of revenue and expenses to segments under FAS 131 most often reflect legitimate reporting decisions. For example, activities that are not controlled by segment-level managers, or that are transitory in nature, are excluded from segment earnings. However, evidence also exists suggesting that managers appear to use FAS 131 discretion opportunistically to make segment profitability less transparent.

However, our results regarding the consequences of Gaps suggest that the benefits of allowing managerial discretion outweigh the costs in the sense that segment earnings with Gaps provide better information to investors, at least for the majority of firms with negative Gaps (72%). This should alleviate concerns regarding the presentation of segment earnings with Gaps to investors.

The remainder of the paper is organized as follows. Background section introduces the provisions of FAS 131 that

[4] It is important to understand that companies can use *segment* income recognition methods that are not allowed, under GAAP, as *corporate* income recognition methods. This is not a violation of GAAP. The Securities Exchange Commission (2003, 8) makes this clear: "Under FASB Statement 131, a company may determine segment profitability on a basis that differs from consolidated operating profit as defined by GAAP."

[5] For example, FAS 131 allows segment earnings to be measured as 'economic value added,' which typically involves expensing the cost of equity capital employed.

[6] The operational definitions of comparable corporate earnings and of aggregated segment earnings are introduced in a subsequent section.

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