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Earnings management in India: Managers' fixation on operating profits

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ABSTRACT

We present evidence that the managers of Indian firms fixate on operating profits, and thus manage such earnings. Specifically, they shift operating expenses to income-decreasing special items in order to inflate operating earnings (McVay, 2006. *The Accounting Review, 81(3)*, 531). We also shed light on another form of classification shifting and find that the managers of Indian firms also engage in netting income-increasing special items against the core expenses in order to inflate core earnings. Given the environment of comparatively weaker corporate governance and investor protection, our results suggest that the magnitude of classification shifting is much more in Indian firms as compared to firms in the United States and East-Asian countries. We also find financial distress to be an important firm characteristic that is likely to influence the managers to engage in classification shifting, and find that financially distressed firms are more likely to engage in both types of classification shifting.

1. Introduction

Earnings management has been an active topic of discussion among accounting researchers. This literature has primarily focused on the use of accruals earnings management (Dechow & Schrand, 2004; Dechow, Ge, & Schrand, 2010) and real earnings management such as cutting discretionary spending on research and development, selling, general and administrative expenses, giving price discounts to increase sales, and overproduction to reduce cost of goods sold expense (Roychowdhury, 2006; Gunny, 2010).

McVay (2006) discusses a third tool to manage earnings: classification shifting—shifting of operating expenses to special items in order to inflate core or operating earnings. When managers shift operating expenses to income-decreasing special items (like restructuring costs), operating earnings increase keeping net income unchanged. This behavior of managers is consistent with the evidence that the placement of a line item in the income statement matters to investors and affects stock valuation (Bartov & Mohanram, 2014).

McVay's (2006) findings have been supported by Fan, Barua, Cready, and Thomas (2010) who find that classification shifting is more likely to happen in the fourth quarter than in the first three quarters. Cain, Kolev, and McVay (2013) also find evidence that managers misclassify core expenses. Further, there is evidence on the use of this expense shifting by

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firms in the East Asian countries (Haw, Ho, & Li, 2011). Throughout this paper, *expense shifting* refers to shifting of operating expenses to income-decreasing special items, and *income netting* refers to shifting (netting) of income-increasing special items to (against) operating expenses.

In this paper, we take the existing literature on classification shifting forward and explore the use of another type of classification shifting which involves shifting (netting) of income-increasing special items to (against) core expenses in order to inflate the core income. The empirical evidence in this paper complements the recent anecdotal evidence in the United States, where IBM and Waste Management allegedly used gain on sale of assets to offset operating expenses (Maremont & Bulkeley, 2002; McVay, 2006).

We also find financial distress to be an important firm characteristic that is likely to influence the managers to engage in classification shifting. We posit and find that financially distressed firms are more likely to engage in both expense shifting and income netting, as such firms are more likely to value pro forma earnings and to report special items. Reporting of special items is likely to increase the opportunity for these firms to engage in classification shifting.

We focus on an emerging market, India, which is characterized by weak corporate governance and investor protection (Narayanaswamy, Raghunandan, & Rama, 2012). Further, the corporate landscape is dominated by the family firms and business groups. Founding owners and controlling shareholders have significant influence in the internal decision-making of the firm.

Consequently, there is evidence that Indian firms engage in accruals earnings management (Ajit, Malik, & Verma, 2013; Goel, 2012; Chipalkatti & Rishi, 2007; Rudra & Bhattacharjee, 2012; Gakhar, 2014; Sarkar, Sarkar, & Sen, 2008). The country also has recently witnessed a major accounting fraud at Satyam Computer Services Limited, where earnings and asset values were overstated.

Using a rich data set of special items, segregated into income-increasing and income-decreasing special items, we find that the managers of Indian firms fixate on operating profits. They engage in income netting in order to inflate core earnings, and this impact on core earnings averages around Indian National Rupees (INR) 15 million (Euro 0.20 million, 0.17 percent of assets) per firm-year. This impact on core earnings is over and above what is caused by the shifting of operating expenses to income-decreasing special items that approximates INR 6.5 million (Euro 0.09 million, 0.07 percent of assets) per firm-year. Further, on average, financially distressed Indian firms are likely to incrementally net approximately INR 4.16 million (Euro 0.06 million, additional 0.05 percent of assets) of income-increasing special items against the operating expenses every year. This amount is about INR 1.10 million (Euro 0.01 million, additional 0.01 percent of assets) of core expenses shifted to income-decreasing special items per firm every year.

Our results suggest that the magnitude of classification shifting is likely to be more in the Indian firms as compared to firms in the United States and East-Asian economies. Specifically, managers here are likely to misclassify core expenses as income-decreasing special items about nine (one and a half) times more than those in the United States (East-Asian countries). Similarly, they are likely to net income-increasing special items against the core expenses about five times more than those in the East-Asian countries.

Our paper proceeds as follows. In the next section, we present the literature on classification shifting. Section 3 discusses the motivation for this study and our hypotheses. Section 4 details research design. In Section 5, we discuss our sample selection and descriptive statistics. Section 6 contains results, and we conclude in Section 7.

2. Literature review

The literature on classification shifting has evolved since 2006, when McVay (2006) presented first evidence on the use of this earnings management tool by firms in the United States. She developed a model to estimate expected and unexpected core earnings and found that managers shifted operating expenses to income-decreasing special items in order to inflate core earnings. This behavior of managers is consistent with the evidence that the placement of a line item in the income statement matters to investors and affects stock valuation (Bartov & Mohanram, 2014). However, investors are unable to disentangle such shifting when it is done. Once they learn about it, on the recurrence of shifted operating expenses at the original place next year, they punish the stock (McVay, 2006).

Fan et al. (2010), using a modified core earnings expectation model, also find an evidence of classification shifting. They observe that shifting is more likely to happen in the fourth quarter than in the first three quarters. Barua, Lin, and Sbaraglia (2010) document that managers shift operating expenses to income-decreasing discontinued operations. Cain et al. (2013) find that managers misclassify not only current core expenses but also past and future core expenses to income-decreasing special items.

Recently Lail, Thomas, and Winterbotham (2014) suggest that managers shift expenses even among the segments within a firm. They find that, in the presence of agency problems, expenses are shifted from core segments to the corporate/other segment, increasing the reported performance of underperforming core segments. If firms operate in less competitive industries, corporate/other expenses are shifted to core segments, concealing the core profits.

A primary incentive to engage in classification shifting comes from managers' desire to meet or beat earnings benchmarks (Fan et al., 2010) and achieve positive surprises to analysts' forecasts (McVay, 2006; Fan et al., 2010; Athanasakou, Strong, & Walker, 2011; Lin, Radhakrishnan, & Su, 2006; Haw et al., 2011). Managers also engage in classification shifting prior to seasoned equity offerings to influence the investment decision of potential investors (Siu & Faff, 2013).