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Who classifies interest payments as financing activities? An analysis of classification shifting in the statement of cash flows at the adoption of IFRS



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A B S T R A C T

In this study, we examine a firm's classification shifting behavior in the statement of cash flows under the IFRS regime. Specifically, we examine the determinants and economic consequences of classification shifting to manage operating cash flows. Based on a sample of firms that mandatorily adopt IFRS in Korea, the result shows that financially distressed firms, firms with high interest payments, firms with high bank ownership, and *Chaebol* affiliated firms tend to shift their interest payments from operating to financing cash flows, thereby increasing the total amounts of operating cash flows. We also find evidence largely consistent with the view that investors discount operating cash flow surprises from classification shifting. Overall, we provide initial evidence that classification shifting exists in the statement of cash flows under the IFRS regime and its economic consequences are significant.

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1. Introduction

In this study, we examine the determinants and economic consequences of classification shifting within the statement of cash flows under the International Financial Reporting Standards (IFRS) regime.¹ In particular, we examine whether interest payments are opportunistically classified as financing activities instead of operating activities in the statement of cash flows and, if so, whether capital market participants impound the information in firm valuation. Interest payments are generally of great concern to firms because they account for a significant portion of cash flows and are often associated with debt covenants.² Interest payments were required to be classified as operating cash flows (OCF) before the adoption of IFRS in Korea.³ On the other hand, the International Accounting Standards (IAS) 7 *Statement of Cash Flows* allows managers considerable discretion when presenting the statement of cash flows. Specifically, IFRS (IAS 7.31) enables firms to classify interest payments as either operating or financing activities. In the presence of this discretion related to the classification of interest payments, we expect that certain managers have incentives to shift interest payments from *operating* to *financing* activities to increase OCF.

The statement of cash flows is one of the key financial statements that investors rely on for firm valuation. In particular, investors advocate the use of OCF to ascertain the credibility of accrual-based earnings because they believe that OCF is difficult to manipulate and it comes from the main revenue-producing activities of the firm. As seen in the significant accounting scandals of the early 21st century, such as Enron and WorldCom, investors pay more attention to OCF, and an increasing portion of security analysts tend to disseminate cash flow forecasts in recent years. Call et al. (2009) show that the number of firms that have at least one analyst cash flow forecast has substantially increased from 233 firms in 1993 to 3375 firms in 2008. Minton and Schrand (1999) provide evidence that OCF is directly related to the interest payment ability of companies. More importantly, OCF has been widely used for valuation among analysts (Block, 1999). Similarly, DeFond and Hung (2003) show that OCF is incrementally important for valuation. Considering the increased importance of OCF, firms have strong incentives to report higher OCF in their statements of cash flows. In other words, firms are likely to report high levels of OCF to provide the market with positive perceptions of firm value and future cash flows. Anecdotal evidence from the financial press also suggests that some firms that voluntarily adopt IFRS tend to exploit the discretion provided by the IFRS in reporting their statements of cash flows. Concerns have been raised that the inflation of OCF would undermine the comparability of financial statements in the financial press (The Korea Economic Daily, 2009).

In this paper, we select a sample of Korean firms to investigate the influence of the adoption of IFRS on the classification choices of interest payments in the statement of cash flows. We choose Korean firms as our sample for several reasons. First, Korea fully adopted IFRS in 2011, supplanting the Korean GAAP, which is very compatible to the U.S. GAAP. The adoption of IFRS in Korea has resulted in debates on the costs and benefits of IFRS and sheds light on the potential effect of the adoption of IFRS by U.S. firms.

Second, our motivation to use Korean firms comes from prior literature suggesting that classification shifting activities are likely to differ in a bank-centered economy. Compared to the U.S., which is a capital-market centered economy, Korean firms rely significantly more on bank financing (Kang et al., 2010). The influence of banks on borrowing firms has been particularly significant during the financial crisis in Korea in the late 1990s (Ferri et al., 2001; Bae et al., 2002b). The importance of bank debt financing has continuously increased since the financial crisis. Over the past decade, Korean firms have relied on banks for more than 40% of their financing, which is significantly higher than 20% for U.S. firms (Bank for International Settlements, BIS Quarterly Review, 2014). This evidence suggests that bank debt financing plays a major role in the external financing of Korean firms. Consequently, interest payments to the bank is a major cash outflow and is an important determinant of financial health for firms in bank-centered financial systems, such as that of Korea. To the extent that OCF is an important

¹ Similar to prior research, we define classification shifting as the deliberate classification of items within the statement of cash flows.

² In our sample firms, a firm's interest payment accounts for approximately 4% of its market capitalization, and the amount of classification shifting related to the interest payment is approximately 7% of total assets.

³ The previous Korean Generally Accepted Accounting Principles (GAAP) is comparable to US GAAP, which requires interest payments to be classified as OCF.

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