Abstract

In this dissertation, I focus on the misclassification of items in the financial statements in order to inflate operating earnings or cash flows. First two essays examine this misclassification in the income statement, while the final essay does so in the cash flow statement.

McVay (2006) presents evidence that managers inflate core or operating earnings by shifting operating expenses to special items. In the first essay of this dissertation, I improve McVay's (2006) model to estimate core earnings by controlling for firm's fundamental operating performance effectively. McVay (2006) suggests that poorly performing firms, which are more likely to report income-decreasing special items, may elect to temporarily reduce discretionary spending leading to a positive association between the income-decreasing special items and unexpected core earnings. This positive association may then be incorrectly inferred as evidence of classification shifting. Hence, I control for those managerial actions which can impact the level of discretionary expenses and inventory, in order to estimate the unexpected core earnings. Using modified models, which exhibit better explanatory and forecasting power, I continue to find evidence of classification shifting for my full sample (1990-2010). I find that McVay's (2006) model seems to overstate the magnitude of shifting due to insufficient control for performance, and likelihood of presence of poorly performing firms in the sample. Her model also fails to show classification shifting using shiftable income-decreasing special items, while the models proposed are able to do so. I also find that classification shifting continues to exist in the recent period (2001-2010) and in fact, its magnitude has increased. Overall, my models improve identification and understanding of classification shifting.

In the second essay, I focus on an emerging market, India, and examine whether the managers of Indian firms also engage in this type of classification shifting. I also take the existing literature on classification shifting forward and explore the use of another type of classification shifting which involves shifting of income-increasing special items to core or operating expenses. I find that the managers of Indian firms engage in both forms of classification shifting. I also link the use of classification shifting with financial distress and show that distressed firms are more likely to engage in both types of classification shifting.

In final essay, I present large-sample evidence that the managers of Indian firms manipulate operating cash flows by using four different misclassification strategies. Specifically, they shift operating cash outflows to investing and financing cash outflows, and investing and financing cash inflows to operating cash inflows. I also find that the financially distressed firms are more likely to manipulate operating cash flows by engaging in the misclassification of cash flows.