

Research on Classified Transfer Earnings Management under Listing Threshold Pressure

Xiulin Tan

Shanghai University, Shanghai, China

Abstract

Earnings management is the behavior that managers use their professional skills and professional judgment to manipulate financial statements and affect stock prices, so as to mislead the internal and external stakeholders of the company. This paper takes the classification transfer earnings management behavior as the entry point, theoretically discusses the motivation and premise of the behavior, and in view of the important review role of regulators in the listing process, selects Chinese IPO companies listed in A-shares as samples, and conducts an empirical study on the classification transfer earnings management under the listing threshold pressure. Moreover, it further analyzes the managers' preferred means of classification transfer earnings management and the influence of audit behavior on this behavior. The research results of this paper reveal that the existing accounting standards focus on the recognition and measurement of accounting elements, ignoring the classification of accounting elements, which is helpful for relevant regulators to pay attention to this new earnings management means, and help investors accurately evaluate enterprise value.

Keywords

Earnings Management; IPO; Issue Review System.

1. Introduction

Earnings management means that managers use their professional skills and professional judgment to manipulate financial statements and affect stock prices, so as to mislead internal and external stakeholders of the company. They usually take the company's business performance as the basis for decision-making. At present, the mainstream research direction of domestic and foreign scholars is manipulative accruals and real activity manipulative earnings management behavior, while the classification transfer earnings management behavior is ignored. In this way, the profit structure is adjusted without changing the net profit, and the core expense items are classified and transferred to the special expense items. The ultimate goal is to improve the core earnings. Classified transfer earnings management was first discovered by McVay (2006). She also proposed that the main reason why American listed companies widely adopt classified transfer earnings management is to cater to institutional investors and analysts in the capital market. Due to the strong persistence of core earnings, investors and analysts can obtain more information from it when evaluating enterprise value. Therefore, paying more attention to core earnings enables them to predict future business performance and enterprise value more accurately.

In our capital market, in addition to investors, regulators also play an indispensable role, responsible for a series of important regulations, including listing conditions, additional issuance conditions, information disclosure and so on. As users of accounting information with professional knowledge, regulators will not only focus on the total amount of earnings, but also on the persistence of earnings. Therefore, in order to cater to the regulators, the company's management also generates the incentive of classified earnings management. The role of

regulators in IPO reviews is typical. Although China's capital market access system has gradually changed to the registration system since 2020, it will be a gradual process. Chinese IPOs, especially in the A-share market, are still difficult to completely abandon the characteristics of the substantive review by the CSRC. Under the existing capital market access system, Chinese regulatory authorities require IPO companies to provide financial reports and audit reports of the last three years, and set the minimum performance threshold, which is based on "net profit and net profit after deducting non-recurring gains and losses", which shows how much attention regulators pay to core earnings. This paper mainly studies whether the listed companies have the classification transfer earnings management behavior in the IPO process, and discusses the motivation and preference of the behavior.

2. Theoretical Basis

2.1. View of Opportunism

American economist Coase believes that a company is a collection of resources combined by various subjects through a series of contracts, and the market needs to supervise these contracts to a certain extent to ensure that they are not violated, while enterprise behavior is the result of constant game between various contract subjects for interests. Therefore, from the perspective of contract, earnings management is regarded as the management's opportunistic behavior. The use of accounting data is reflected in many contracts, such as the debt contract between debtors and creditors, the salary contract of employees, etc., in order to constrain the behavior of all parties in these contracts, it is necessary to specify the corresponding standards, accounting data has become one of the important standards, accounting standards are also produced. However, the code itself is also a kind of public contract. The makers of the code seek to meet the needs of all parties to reduce the total cost and reduce the conflicts between them. Compared with accounting standard setters, managers can judge economic matters more quickly and accurately and make corresponding decisions. Such information asymmetry spawns managers' opportunism. They make use of their own advantages to flexibly choose accounting treatment methods to achieve their own goals. But it also undermines the interests of other stakeholders.

2.2. Asymmetry of Information

In the imperfect capital market, there is a natural information asymmetry between the company's management and other stakeholders, which is difficult to eliminate. No matter what accounting method is chosen, it is difficult for accounting information to reflect the actual situation of the enterprise in the most true and accurate way, and it cannot accurately convey the signal of judging enterprise value to the outside world. In the view of information, financial data has information content, but it is only one of many decision signals, and external stakeholders will not directly regard it as a profit concept of real value. Earnings management is not all opportunism, the company management can choose more appropriate accounting treatment methods within a certain space, in order to better convey the information of the company's operating conditions. It can be seen that information communication barriers between managers and other stakeholders are likely to reduce the efficiency of contracts, and earnings management as a tool to reduce communication barriers is moderately beneficial. From the perspective of information, managers prefer to convey the long-term and sustainable profit potential of an enterprise. However, such information, such as corporate strategy and changes in market environment, is often complex, and direct communication of such information is very complicated. In this case, managers will make reasonable choices of accounting policies in order to convey such information to investors.

2.3. Persistence of Earnings

Earnings persistence is the best reflection of earnings quality. In order to make the earnings structure in the income statement more clear and help information users better use it to forecast the future performance, Graham and Dodd first divided the earnings into permanent earnings and temporary earnings in 1934. Permanent earnings refer to the core earnings, which can be obtained repeatedly in the company. Usually, it can better predict the future performance. The higher the proportion, the more stable the company's operating condition, such as the main business income; Temporary earnings are one-time earnings that occur during the accounting period, such as gains and losses from the disposal of non-current assets. In 1998, Ramakrishnan and Thomas added the third category, price-independent surplus, which refers to the surplus generated due to the change of accounting policies. Compared with the other two types of surplus, permanent surplus is more sustainable and has more reference value. Therefore, professional financial statement users usually give a higher weight to permanent earnings, and also find that the earnings structure items have a stronger ability to predict the company's future performance and value than the total earnings. It can be seen that earnings persistence is a very important measurement factor among the variables to predict future performance.

3. Research Hypotheses

Domestic and foreign studies generally find that listed companies have earnings management behavior in the IPO process, which is not only to achieve the purpose of raising the stock issue pricing, but also to meet the regulatory authorities to reach the threshold of listing. However, most scholars' research is limited to manipulative accruals and manipulation of real activities in earnings management, and they ignore the classification transfer earnings management method, which changes the profit structure without changing the total profit by transferring core expenses by classification. Under the current capital market system, if a company wants to go public, it needs to meet the corresponding minimum threshold, which is based on "net profit and net profit of deducting non-recurring profit and loss". Classified transfer transfers core expenses to non-operating expenses, and it is very likely to increase the net profit under the principle of "non-recurring profit and loss" when the non-recurring profit and loss is greater than zero. In addition, the audit committee composed of experts prefer to pay more attention to the earnings sustainability of listed companies in the substantive audit, which is often represented by the core earnings.

Therefore, this paper believes that under the current special capital market access system, listed companies have the motivation to adopt earnings transfer management by classification in the IPO process in order to pass the audit and improve the stock pricing. However, after the successful IPO of listed companies, the performance standard of special treatment (ST) and delisting regulation rules changes to "net profit" instead of "net profit under the principle of which is lower"; At the same time, after the IPO, listed companies are faced with a capital market dominated by retail investors, who only care about "net profit" rather than earnings structure information. It can be seen that the classification transfer earnings management motivation of listed companies almost disappears after successful listing, and it is likely that classification transfer will not be implemented again. Based on this, this paper proposes hypothesis 1:

H1: Classified earnings transfer management behavior of Chinese listed companies only exists in the first three years of IPO, and will disappear three years after successful IPO.

The core expenses are divided into operating costs and period expenses in the study of classification transfer. The gross profit of an enterprise can be obtained by subtracting operating costs from operating income, while the core earnings can be obtained by subtracting operating costs and period expenses from operating income. Gross profit is an important

indicator to reflect the profit potential of enterprises and an important source of core earnings. If the listed company transfers the operating cost classification to non-operating expenses, it can not only increase the gross profit of enterprises, but also increase the core earnings and show better earnings sustainability. If the period expenses are classified and transferred to non-operating expenses, it can only increase the core earnings but not the gross profit. Therefore, listed companies may prefer to transfer operating costs to non-operating expenses in the process of listing. Based on this, this paper proposes hypothesis 2:

H2: Chinese listed companies prefer to classify operating costs rather than period expenses in the IPO process.

4. Research Design

4.1. Sample and Data Source

In this paper, 1,545 listed companies with successful A-share ipos from 2011 to 2021 are selected, and key variables such as ST companies, financial industry, total assets and operating income are missing, as well as samples with annual industry sample size less than 15 are excluded. Then the main financial data of the three years before IPO, the year of IPO and the three years after IPO are selected for the screened samples, including operating revenue, operating costs, sales expenses, financial expenses, administrative expenses, non-operating expenses, net profit, total assets, net profit attributable to the shareholders of the listed company after deducting non-recurring gains and losses, etc. Finally, all continuous variables were treated with 1% bilateral tail reduction, and a total of 9121 samples were obtained, including 3760 samples in the first three years of IPO, 1546 samples in the year of IPO, and 3815 samples in the three years after IPO.

4.2. Variable Design and Modeling

This paper draws on McVay's (2006) classification transfer earnings management expectation model, and adopts model (1) to perform regression by industry and year to obtain regression coefficient, which can estimate the projected core earnings. Then subtract the actual core earnings (CE_t) from the expected core earnings, which is the unexpected core earnings (UE_CE_t). Model (2) is then used to test hypothesis 1 by regression of unexpected core earnings (UE_CE_t) and non-operating expenses (SI_t). If the coefficient β_1 is significantly positive, it indicates that the listed company has classified transfer earnings management behavior, otherwise it does not exist.

$$CE_t = \alpha_0 + \alpha_1 CE_{t-1} + \alpha_2 ATO_t + \alpha_3 ACCRUALS_{t-1} + \alpha_4 \Delta SALES_t + \alpha_5 NEG_ \Delta SALES_t + \varepsilon_t \quad (1)$$

$$UE_CE_t = \beta_0 + \beta_1 SI_t + \sum YEAR + \sum IND + \varepsilon_t \quad (2)$$

Model (3) and model (4) are used for industry-specific and year-specific regression to get the regression coefficient, estimate the estimated operating costs and period expenses, and then calculate the unanticipated operating costs (UE_COGS_t) and unanticipated period expenses (UE_SGA_t) respectively according to the actual operating costs and period expenses. Using model (5), unanticipated operating costs (UE_COGS_t) and non-operating expenses (SI_t) are regressed. Using model (6), unanticipated period expenses (UE_SGA_t) and non-operating expenses (SI_t) are regressed to test hypothesis 2. If the coefficient δ_1 is significantly negative, it means that the listed company has adopted the method of transferring the operating cost classification to non-operating expenses. If the coefficient ρ_1 is significantly negative, it means that the listed company has adopted the way of transferring the period expense classification to non-operating expenses, otherwise it means that it has not adopted this way.

$$COGS_t = \gamma_0 + \gamma_1 A_t + \gamma_2 COGS_{t-1} + \gamma_3 ACCRUALS_t + \gamma_4 ACCRUALS_{t-1} + \gamma_5 SALES_t + \gamma_6 NEG_SALES_t + \varepsilon_t \quad (3)$$

$$SGA_t = \mu_0 + \mu_1 A_t + \mu_2 SGA_{t-1} + \mu_3 ACCRUALS_t + \mu_4 ACCRUALS_{t-1} + \mu_5 SALES_t + \mu_6 NEG_SALES_t + \varepsilon_t \quad (4)$$

$$UE_COGS_t = \delta_0 + \delta_1 SI_t + \sum YEAR + \sum IND + \varepsilon_t \quad (5)$$

$$UE_SGA_t = \rho_0 + \rho_1 SI_t + \sum YEAR + \sum IND + \varepsilon_t \quad (6)$$

5. Empirical Analysis

5.1. Descriptive Statistics

Descriptive statistics are conducted according to the sample data obtained above, as shown in Table 1.

Table 1. Descriptive statistics

	(1)	(2)	(3)	(4)	(5)
VARIABLES	N	mean	sd	min	max
CE _t	9,121	0.0900	0.242	-12.12	0.421
SI _t	9,087	0.00273	0.0144	0	0.852
ΔSALES _t	8,356	0.208	0.313	-1.309	1.640
NEG_ΔSALES _t	8,356	-1.466e+08	6.184e+09	-5.575e+11	0
ATO _t	8,361	1.392	1.429	0.189	43.18
A _t	8,353	1.46e-09	2.31e-09	0	5.63e-08
COGS _t	9,121	0.663	0.172	0.128	0.951
SGA _t	9,095	0.190	0.121	0.0312	0.648
CEO	8,528	0.0869	0.293	-17.55	0.420
ACCRUALS ₀	8,526	-0.00282	0.401	-23.01	0.467
COGS ₀	8,528	0.663	0.172	0.121	0.952
SGA ₀	8,507	0.191	0.122	0.0315	0.663

5.2. Difference Test before and after IPO

Table 2. T-test of the main variable of the three years before and three years after IPO samples

	three years before IPO	three years after IPO	difference	t-value
ΔSALES _t	0.21135	0.21243	-0.00108	-0.138
CE _t	0.07898	0.08037	-0.00139	-0,231
UE_CE _t	0.14319	0.00991	0.13328	2.144**
ATO _t	1.42398	1.42341	0.00057	0.016
ACCRUALS _t	-0.01305	0.00732	-0.00573	-0.915
SI _t	0.00297	0.00290	0.00007	0.201

Table 2 shows the T-test of the main variables of the samples three years before IPO and three years after IPO. The results show that the unexpected core earnings (UE_ CE_t) of the samples three years before IPO is significantly higher than the samples three years after IPO at the level of 5%, which conforms to the sample characteristics of classified transfer earnings management

behavior in the three years before IPO, and preliminarily validates the theoretical analysis above.

5.3. Analysis of Regression

5.3.1. H1 Regression

It can be seen from Table 3 that in the first three years of IPO, the coefficient of non-operating expenditure (SI_t) is 1.09927, that is, there is a positive correlation between unanticipated core earnings and non-operating expenditure, indicating that the listed company has classified earnings transfer management behavior in the first three years of IPO. In the IPO year, the coefficient of non-operating expenses (SI_t) is 0.91193, that is, the unexpected core earnings and non-operating expenses are also positively correlated, indicating that the classified transfer earnings management behavior still exists in the IPO year. However, three years after IPO, the coefficient of non-operating expenses (SI_t) is -3.44453, and there is a negative correlation between unanticipated core earnings and non-operating expenses, indicating that there is no classification transfer behavior three years after IPO, which verifies hypothesis 1. It can be concluded that there exists earnings management behavior of classified transfer in the IPO process of listed companies, and its motivation is to meet the regulatory authorities to reach the listing threshold. However, after IPO, listed companies mainly face more retail investors in the capital market rather than professional investors, and the motivation of classified transfer gradually disappears.

Column (4) is to use the samples of the first three years and the three years after the IPO, and add DUM dummy variable, that is, the value of the first three years is 1, and the value of the three years after the IPO is 0. The final regression result shows that the coefficient of $DUM \times SI_t$ is 4.5893, which further indicates that compared with the three years after the IPO, There is indeed stronger classification transfer earnings management before IPO, which further verifies hypothesis 1.

Table 3. Unanticipated regression results of core earnings and non-operating expenses

variable	Explained variable: UE_CE _t			
	(1) three years before IPO	(2) Year of IPO	(3) three years after IPO	(4) Three years before and after the IPO
SI_t	1.09927*** (0.74)	0.91193** (0.19)	-3.44453** (-1.09)	-3.5872 (-1.45)
DUM				0.12244 (1.93)
$DUM \times SI_t$				4.5893* (1.23)
constant term	0.14193 (0.24)	0.31384 (3.93)	0.01976 (0.01)	0.01533 (0.02)
YEAR	control	control	control	control
IND	control	control	control	control
Quantity	2981	1392	3398	6380
R ²	0.025	0.035	0.004	0.006
Adj.R ²	0.018	0.026	-0.002	0.002
F	3.80	3.81	0.62	1.63

5.3.2. H2 Regression

Table 4 shows the regression results of the unanticipated operating costs, unanticipated period expenses and non-operating expenses of the samples in the first three years of IPO, respectively, to verify hypothesis 2. Column (1) shows the regression results of unanticipated operating costs and non-operating expenses. The coefficient of non-operating expenses (SI_t) is -0.24431, indicating that the listed company adopted the classified transfer method of transferring operating costs to non-operating expenses in the IPO process. Columns (2) and (3) further divide the samples of the first three years of IPO into manufacturing enterprises and non-manufacturing enterprises. It can be found that such a classification transfer mode exists in manufacturing enterprises, but does not exist in non-manufacturing enterprises, which further verifies hypothesis 2. Column (4) shows the regression results of unexpected period expenses and non-operating expenses, and the coefficient of SI_t is 0.59667. There is a positive correlation between unexpected period expenses and non-operating expenses, indicating that the listed company did not adopt the classified transfer method of transferring period expenses to non-operating expenses in the IPO process, which also verifies hypothesis 2.

Table 4. Unanticipated operating costs and unanticipated periods

variable	UE_COGS _t			UE_SGA _t
	(1)three years before IPO	(2) Manufacturing	(3) Non-manufacturing	(4) three years before IPO
SI _t	-0.24431** (-1.12)	-0.31577** (-1.32)	0.27985** (0.49)	0.59667*** (1.83)
constant term	0.17450 (4.32)	0.20294 (4.35)	0.07981 (1.07)	-0.24813 (-4.12)
YEAR	control	control	control	control
IND	control	control	control	control
Quantity	2976	2221	754	2967
R ²	0.074	0.075	0.088	0.061
Adj.R ²	0.068	0.069	0.066	0.055
F	12.34	11.98	3.96	10.13

5.3.3. Further Study

First, the group test is conducted according to the positive and negative non-recurring profit and loss. Only under the condition that the non-recurring profit and loss is greater than zero, the classification transfer can improve the net profit under the maturity high condition, make the IPO company reach the performance threshold, improve the stock pricing and show more earnings persistence. Column (1) of Table 5 shows the sample regression results when the non-recurring profit and loss is greater than zero, and column (2) shows the sample regression results when the non-recurring profit and loss is less than zero. It can be found that only when the non-recurring profit and loss is greater than zero, the non-operating expenditure (SI_t) coefficient is positive, that is, only when the non-recurring profit and loss is greater than zero can there be classified transfer behavior.

Then, the group test is conducted according to the big Four and non-big four. Existing studies have found that the improvement of audit quality can reduce classification transfer. Columns (3) and (4) in Table 5 show the regression results of the Big Four and non-Big Four audit respectively. In the sample group of the four audit companies, the coefficient of SI_t is negative,

indicating that there is no classification transfer behavior. In the non-Big Four audit sample group, the non-operating expenditure (SI_t) coefficient is 1.60819, indicating the existence of classification transfer, which tentatively suggests that the Big Four are able to inhibit classification transfer to some extent.

Table 5. Further group tests

	UE_CE _t			
variable	(1) Non-recurring profit and loss is positive	(2) Non-recurring profit and loss is negative	(3) big4	(4)not the big4
SIt	10.54506 (2.57)	-1.71027 (-1.17)	-43.03 (-0.46)	1.60819 (0.78)
constant term	0.18734 (0.43)	-0.67761	0.01876 (0.01)	0.04802 (0.14)
YEAR	control	control	control	control
IND	control	control	control	control
Quantity	2109	164	100	2173
R ²	0.027	0.235	0.133	0.027
Adj.R ²	0.019	0.146	-0.032	0.019
F	3,37	2.65	0.80	3.49

6. Conclusion

Under the current Chinese capital market system, the performance of the company to be listed needs to reach a certain threshold for successful IPO and pass the review of the Commission of China Securities Regulatory Commission. The threshold is based on the standard of "which is lower than net profit and net profit after deduction", and the earnings per share referred to in stock pricing is also based on this standard. And the experts of the Commission and institutional investors in the market are more concerned about the sustainability of the earnings. Under such a background, companies to be listed have a strong incentive to classify transfer earnings management. This paper takes IPO listed companies from 2011 to 2021 as the observation samples and draws the following conclusions after empirical analysis:

(1) In the three years before IPO and the year, there is a positive correlation between the unexpected core earnings and the regression of non-operating expenses, indicating the existence of classified transfer earnings management; Three years after the IPO of the listed company, this positive correlation no longer exists, indicating that the earnings management behavior no longer exists. (2) In the three years before IPO of listed companies, there is a negative correlation between the unanticipated operating costs and the regression of non-operating expenses, and there is a positive correlation between the unanticipated period expenses and the regression of non-operating expenses, indicating that the classified transfer of earnings management behavior of listed companies mainly adopts the way of transferring operating costs rather than period expenses to non-operating expenses. (3) In the further analysis, only when the non-recurring profit and loss is greater than zero, there is a positive correlation between the regression of unexpected core earnings and non-operating expenses, indicating that the premise of classified transfer earnings management of listed companies is non-recurring profit and loss is greater than zero; Subsequently, it is found that the classification transfer behavior is more obvious in the sample group of non-Big Four auditing

listed companies, indicating that high-quality auditing can inhibit this behavior to a certain extent.

References

- [1] Misclassifying Core Expenses as Special Items: Cost of Goods Sold or Selling, General, and Administrative Expenses?[] . Yun Fan,Xiaotao (Kelvin) Liu. Contemporary Accounting Research . 2017 (1).
- [2] Principles-Based Standards and Earnings Attributes[] . David Folsom,Paul Hribar,Richard D. Mergenthaler,Kyle Peterson. Management Science . 2016.
- [3] Earnings Management Constraints and Classification Shifting[] . John L. Abernathy,Brooke Beyer,Eric T. Rapley. Journal of Business Finance & Accounting . 2014 (5-6).
- [4] An exploratory study of earnings management detectability, analyst coverage and the impact of IFRS adoption: Evidence from China[]. Yongtao Cang,Yiyun Chu,Thomas W. Lin. Journal of Accounting and Public Policy . 2014.
- [5] Earnings Management Constraints and Classification Shifting[]. John L. Abernathy,Brooke Beyer, Eric T. Rapley. Journal of Business Finance & Accounting . 2014 (5-6).
- [6] Managing Earnings Using Classification Shifting: Evidence from Quarterly Special Items[] . Yun Fan,Abhijit Barua,William M. Cready,Wayne B. Thomas. The Accounting Review . 2010.
- [7] The Relation Between Earnings Management Using Real Activities Manipulation and Future Performance: Evidence from Meeting Earnings Benchmarks[]. KATHERINE A.GUNNY. Contemporary Accounting Research . 2010 (3).
- [8] Accrual-based and real earnings management activities around seasoned equity offerings[] . Daniel A. Cohen,Paul Zarowin. Journal of Accounting and Economics . 2010 (1).
- [9] Earnings Management Using Classification Shifting: An Examination of Core Earnings and Special Items [] . The Accounting Review . 2006 (3).
- [10] Are Accruals during Initial Public Offerings Opportunistic?[] . Siew Hong Teoh,T. J. Wong,Gita R. Rao. Review of Accounting Studies . 1998 (1).