Corporate Governance and Earnings Management by Misclassification:
A Study of Eight East Asian Economies

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ABSTRACT

This study examines earnings management by misclassification in the East Asia, and whether the misclassification effects vary with country and firm level corporate governance mechanisms. Using 3,992 firm-year observations from the eight East Asian economies for the period of 2001 to 2004, I find a positive relationship between unexpected core earnings and income-decreasing non-core special items and a negative relationship between next-period unexpected changes in core earnings and income-decreasing non-core special items. These associations are robust across both annual and pooled samples. Moreover, misclassification significantly magnifies with the control divergence of the ultimate owners, and significantly intensifies when such expense shifting would enable companies to just meet analyst earnings forecast. Further, common law legal tradition and high disclosure requirements mitigate earnings misclassification whereas quality external auditor (the Big 4) does not seem to play a significant role in curbing misclassification. Finally, investors are temporarily fooled by classificatory management, but disentangle this manipulation and discount firm value in the subsequent year. These findings suggest that expenses misclassification appears to have become a particularly attractive vehicle for managers and ultimate owners to manage earnings reporting, and therefore deserves closer scrutiny and attention from the accounting standards setting bodies across the East Asia. The findings also suggest that good country-level institutional factors can mitigate the effects of poor firm-level governance characteristics, consistent with the notion that private control benefits and agency costs are significantly limited in such an environment.

Keywords: Corporate Governance; Misclassification; Earnings Management
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