Article Title Page

Were Regulatory Changes in Reporting 'Abnormal Items' Justified? Evidence of Intra-Period Classificatory Earnings Management Practices in Australia

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Structured Abstract:

Purpose

Managers generally have discretion in determining how components of earnings are presented in financial statements in distinguishing between 'normal' earnings and items classified as unusual, special, significant, exceptional or abnormal. Prior research has found that such intra-period classificatory choice is used as a form of earnings management. Prior to 2001, Australian accounting standards mandated that unusually large items of revenue and expense be classified as 'abnormal items' for financial reporting, but this classification was removed from accounting standards from 2001. This move by the regulators was partly in response to concerns that the abnormal classification was being used opportunistically to manage reported pre-abnormal earnings. This study extends the earnings management literature by examining the reporting of abnormal items for evidence of intra-period classificatory earnings management in the unique Australian setting.

Design/methodology/approach

This study investigates associations between reporting of abnormal items and incentives in the form of analyst following and the earnings benchmarks of analysts' forecasts, earnings levels, and earnings changes, for a sample of Australian top-500 firms for the seven-year period from 1994 to 2000.

Findings

The findings suggest there are systematic differences between firms reporting abnormal items and those with no abnormal items. Results show evidence that, on average, firms shifted expense items from pre-abnormal earnings to bottom line net income through reclassification as abnormal losses.

Originality/value

These findings suggest that the standard setters were justified in removing the 'abnormal' classification from the accounting standard. However, it cannot be assumed that all firms acted opportunistically in the classification of items as abnormal. With the removal of the standardised classification of items outside normal operations as 'abnormal', firms lost the opportunity to use such disclosures as a signalling device, with the consequential effect of limiting the scope of effectively communicating information about the nature of items presented in financial reports.

Keywords: Earnings management; Abnormal items; Special items; Financial reporting; Accounting standards

Article Classification: Research paper

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Running Heads:

1. Introduction

Generally accepted accounting principles (GAAP) allow management to use discretion in determining how certain items are classified, or where they are reported in the financial statements, referred to in the literature as ‘classificatory choice’. Classification affects where an item is placed in the financial statements and hence can result in more detailed disclosure of an item by means of its placement. For example, if management wishes to distinguish the transitory nature of a transaction from ‘normal earnings’, classifying an item as unusual, special, significant, exceptional, abnormal or extraordinary may achieve this objective.

There is also the view that ‘classificatory choice is a powerful earnings management instrument’ (Beattie, Brown, Ewers, John, Manson, Thomas & Turner, 1994: 807). Classificatory choice is a form of intra-period earnings management, hence there is no effect on bottom-line earnings and, therefore, it is less likely to attract scrutiny from auditors; as it does not affect inter-period earnings, there is no effect on future earnings. Moreover, it is within GAAP and there are no tax consequences (Athanasakou, Strong & Walker, 2007).

The Australian regulatory environment prior to 2001 provides a unique setting to examine intra-period classificatory choice using unusual items. Prior to 2001, the Australian accounting standard AASB 1018: *Profit and Loss Accounts*¹ required companies to classify unusually large items of revenue and expense as ‘abnormal items’ to distinguish such items from ‘normal’ earnings. The ambiguity of AASB 1018 allowed Australian firms flexibility in deciding whether to classify an item as an ordinary item or as an abnormal item. Abnormal items are akin to special items reported in the U.S. and exceptional items reported in the U.K.

Unlike other jurisdictions, AASB 1018 permitted firms to present a separate line item in the income statement to show a sub-total for ‘operating income before abnormal items’. Figure 1 provides an illustrative example of how the line items were typically presented in a firm’s financial statements. As Figure 1 shows, Australian firms reported a sub-total for ‘operating profit before abnormal items’ followed by the line item for earnings classified as ‘abnormal items’ after which a total for net operating profit (loss) after abnormal items before income tax was presented. The line item that financial analysts

¹ Unless stated otherwise, references to accounting standards pertain to accounting standards as they applied during the study period.

focused on and which Australian firms highlighted when reporting on measures of financial performance was the sub-total of ‘profit before abnormal items’.

[FIGURE 1 HERE]

In contrast, the U.S. accounting standard APB 30 *Reporting the Results of Operations* specifically prohibits presentation of income before special items in the financial statements. Thus, for U.S. firms the transitory nature of special items can only be inferred from the separate disclosure of such items, but the effects on ‘normal’ profit cannot be explicitly shown. Firms in the U.K. were required under FRS 3 *Reporting Financial Performance*² to distinguish transitory earnings by disclosing as separate line items in the income statement ‘exceptional items’. However, whilst firms had to disclose detailed information about exceptional items U.K. firms were prohibited from disclosing a sub-total for earnings before exceptional items. As the Australian accounting standard allowed presentation of a sub-total for earnings before abnormal items, the standard provided firms with a tool to use the abnormal classification to shift items from ‘normal earnings’ and focus analysts’ and other users’ attention on that ‘normal’ earnings number.

Whilst there is a body of research that examines exceptional items and special items for classificatory earnings management, no known prior empirical research has investigated whether components of earnings are classified as abnormal for the purposes of intra-period earnings management. Further, research examining special items typically tests for earnings management using only income-decreasing special items (for example, Elliott & Hanna, 1996; McVay, 2006), leaving the examination of classification shifting using income-increasing special items for future research (McVay, 2006). This study extends the earnings management literature by examining both income-increasing and income decreasing abnormal items for evidence of intra-period classificatory earnings management in the unique Australian setting.

For a sample of Australian top-500 companies for the period 1994 to 2000, we examine associations between abnormal items and: earnings levels, earnings changes, analyst following and analysts’ earnings forecast errors. Our findings suggest there is a systematic difference between firm-years that reported abnormal items and firm-years

² Financial Reporting Standard No. 3 (FRS3) regulated the reporting of financial performance by UK firms from 1993 until the adoption of International Financial Reporting Standards in 2005 (Athanasakou et al., 2007).

that reported no abnormal items. Consistent with McVay (2006), our evidence suggests Australian firms used the abnormal classification to shift abnormal losses from earnings before abnormal items to the bottom line net earnings measure of earnings after abnormal items earnings (net income).

The evidence from this study contributes to the accounting change literature. Whilst there is growing acceptance of IFRS, there remains conflicting views of the FASB and the IASB regarding treatment of unusual or infrequent events or transactions. Hence our findings may have implications for the standard setters when considering the presentation of earnings components in financial statements.

The remainder of the paper is organised as follows. Section 2 outlines the classification and presentation of earnings components as mandated in accounting standards. Section 3 presents an overview of the prior literature relevant to the incentives for firms to classify items as abnormal and develops testable hypotheses. The research design of the study is presented in Section 4. Section 5 discusses our empirical results, followed by our conclusions in Section 6.

2. Classification and Presentation of Earnings Components

Over several decades, accounting standards globally have undergone various amendments relating to the classification and presentation of income and expense items. Some of those changes were a response by standard setters to what they considered to be attempts to manipulate the presentation of earnings information to influence financial statement users' perceptions of firms' sustainable earnings. Whilst some amendments increased the scope for classificatory choices, they were also seen as a means of highlighting persistent profitability (Athanasakou et al., 2007). We consider how classificatory requirements and presentation of large or unusual items permitted by accounting standards have changed over time in the jurisdictions of the U.S., the U.K. and Australia. Table 1 summarises the reporting requirements for these jurisdictions.

[TABLE 1 HERE]

2.1 U.S. – *Special Items*

Following the release of Opinion No. 9 by the Accounting Principles Board, U.S. firms for the first time were required to distinguish 'extraordinary items' from ordinary operations. However, there were many variations in the application of extraordinary items and firms were criticised for using the extraordinary items classification to house

large losses as the earnings number reported in the financial press was usually income before extraordinary items (Deming, 1974). The U.S. Financial Accounting Standards Board (FASB) responded by issuing APB 30 *Reporting the Results of Operations* in 1973 which introduced the requirement that extraordinary items be both outside normal operations and non-recurring. This meant that many items previously classified as ‘extraordinary’ would now be classified under a separate category of ‘unusual’ or infrequently-occurring items (para. 26).

Although the change to APB 30 had the desired effect of a decrease in the reporting of extraordinary items, it was accompanied with an increase in the reporting of unusual items and discontinued operations (Jacobs & Herring, 1977). APB 30 refers to these as ‘unusual items’, but these events or transactions are more commonly referred to as ‘special items’ and can be disclosed by either a separate line on the income statement or by way of note disclosure. Although firms are prohibited from disclosing a sub-total for earnings before special items in the financial statements, such pro-forma measures of earnings are often emphasised by the U.S. financial press and by financial analysts. Furthermore, most earnings announcements in press releases ‘identify special items explicitly’ (Elliott & Hanna, 1996: 144) in order to distinguish the transitory nature of special items (Burgstahler, Jimbalvo & Shevlin, 2002; Elliott & Hanna, 1996; Kinney & Trezevant, 1997) from persistent earnings.

2.2 U.K. – Exceptional Items

In the U.K., up until the early 1990s, Statement of Standard Accounting Practice (SSAP) 6 required firms to disclose extraordinary items. The Accounting Standards Board (ASB) replaced the reporting of extraordinary items by issuing in 1992 FRS 3³ *Reporting Financial Performance*⁴ relating to reporting periods ending on or after 22 June 1993. Prior to FRS 3 being issued, SSAP 3 required the calculation of earnings per share to be based on ‘profit after exceptional items⁵ and before extraordinary items’. Firms were accused, however, of recording material one-off (transitory) items as ‘extraordinary’ if they were expenses or losses and as ‘exceptional’ (above ordinary income) if they were transitory revenue or profits thereby maximising the reported

³ FRS3 amended Statement of Standard Accounting Practice No. 3 (SSAP3), issued by the ASB’s predecessor, the Accounting Standards Committee (ASC), and superseded SSAP6.

⁴ Financial Reporting Standard No. 3 (FRS3) regulated the reporting of financial performance by UK firms from 1993 until the adoption of International Financial Reporting Standards in 2005 (Athanasakou et al., 2007).

⁵ “Exceptional items are ‘material items which derive from events or transactions that fall within ordinary activities of the company, and which need to be disclosed separately by virtue of their size or incidence if the financial statements are to give a true and fair view’” (ASC, 1986, cited in Ballas, 1999).

earnings per share which would benefit the firm's share price (Athanasakou et al., 2007; Gore, Pope & Singh, 2007). FRS 3 effectively reclassified all extraordinary items as 'exceptional' and made it clear that the reporting of extraordinary items would be extremely rare thus constraining the use of extraordinary items for earnings management (Gore et al., 2007). FRS 3 gave firms the discretion to classify items as unusual or exceptional allowing firms to distinguish between recurring and transitory earnings. However, others argued that the changes 'encouraged the practice of classificatory smoothing' (Athanasakou et al., 2007: 428).

The changes brought about by FRS 3 were viewed as counter-productive for two reasons. First, the changes in the classification of earnings brought in by FRS 3 meant that many items previously disclosed as an extraordinary item would now be treated as an exceptional item (Ballas, 1999). Gore et al., (2007) present evidence of U.K. companies changing their earnings management strategies subsequent to the issuance of FRS 3. Second, an objective of FRS 3 was to re-focus financial statement users away from relying on one bottom-line earnings figure as a measure of firms' performance. However, subsequent to the implementation of FRS 3, the Institute of Management and Research developed its own earnings measure, being earnings adjusted for unusual/exceptional items (Ballas, 1999). An increase in the number of firms reporting earnings per share on the basis of earnings before exceptional items followed and earnings before exceptional items became the earnings measure used by financial analysts and reported on in press releases (Ballas, 1999).

2.3 Australia – Abnormal Items

In Australia the accounting standard AAS 1: *Profit and Loss Statements* (effective 1 December 1974) made a distinction between operating profit, abnormal items and extraordinary items. Extraordinary items were defined as items of revenue and expense, and other gains and losses attributable to events or transactions outside the ordinary operations of the business entity (para. 4 (d)). Abnormal items (at that time) were defined as items of revenue and expense, and other gains and losses, which although attributable to the ordinary operations of the business entity, are considered abnormal by reason of their size and effect on the results for the period (para. 4 (c)).

Thus, the distinguishing feature between an extraordinary item and an abnormal item (at that time) was that extraordinary items originated outside of the firm's ordinary operations, whereas abnormal items emanated from a firm's ordinary operations but

because of their size and effect warranted separate disclosure. As with their U.S. and U.K. counterparts, Australian firms were also perceived as using the extraordinary classification to manage earnings by classifying large losses as extraordinary, whereas large gains were classified as abnormal items. As the earnings number reported in the financial press was typically ‘earnings before extraordinary items’ classifying large losses as extraordinary allowed firms to report higher earnings before extraordinary items. Empirical research supports the contention that extraordinary items were used to manage earnings (see for example, Craig & Walsh, 1989; Godfrey & Jones, 1999; Walsh, Craig & Clarke, 1991).

Australian standard setters took steps to restrict the reporting of extraordinary items. The (then named) Australian Standards Review Board (ASRB) reissued AAS 1 in conjunction with the issue of ASRB 1018⁶: *Profit and Loss Accounts* effective for financial years ending on or after 31 December 1989 in which the definition of extraordinary items was tightened (along similar lines to APB30 in the U.S.), requiring extraordinary items to be both attributable to transactions outside the ordinary business operations, and non-recurring (ASRB 1018, para. 6).

To assess the impact of the more stringent definition of extraordinary items contained in AASB 1018, Houghton (1994) conducted a study of the changes in reporting of extraordinary items and abnormal items by 91 of Australia’s largest companies⁷ during 1988 to 1991, representing two years prior and two years after the changes to the accounting standard.

Houghton (1994) found that, on average, extraordinary items in 1988 and 1989 were losses, while abnormal items were, on average, gains, but less frequent. Houghton (1994) observed a substantial shift in the number and dollar value of both extraordinary and abnormal items after the definitional change in 1989. The number of extraordinary items dropped by approximately half after the definitional change. In contrast, the number of abnormal items doubled from the pre-definitional change of extraordinary items years. Houghton’s (1994) evidence suggests that the change in definition made extraordinary items a rarer event and concurrently the reporting of abnormal items became more frequent.

⁶ The ASRB series of accounting standards was replaced by the AASB accounting standards series. ASRB 1018 was subsequently reissued as AASB 1018.

⁷ Based on market capitalisation.

Abnormal items also fundamentally changed in nature after the definitional change to extraordinary items. Prior to the change, abnormal items were, on average, consistently profits, whereas after the change abnormal items were, like extraordinary items, on average large losses.

The high frequency of firms reporting loss items as abnormal drew much criticism in the financial press, with comments such as ‘there is no such thing as abnormal profits, only abnormal losses’ (Parker and Porter, 2000:66). As earnings before abnormal items were generally highlighted in media releases, companies were perceived as using abnormal items strategically to smooth and improve reported pre-abnormal earnings (Saunders, 1999). Recall, abnormal items were earnings considered to be abnormal due to their size and effect on earnings, suggesting only large (material) items qualify for classification as abnormal.⁸ Based on the AASB 1031 materiality thresholds, Cameron (2008) examined a sample of 1475 individual abnormal items and found that 27.8% of items were immaterial (fell below the 5% materiality threshold) and 16.3% fell into the ‘grey’ area (5 to 10%) where professional judgement is required to be exercised to determine whether the item is material. Thus a substantial proportion of items classified as abnormal are either immaterial or borderline material, which is inconsistent with the expectation that, by definition, abnormal items are large and therefore clearly material. A possible explanation for this finding is that items may have been classified as abnormal to increase/decrease earnings before abnormal items up/down to an earnings benchmark.⁹

The growing concerns over the reporting of abnormal items led to calls for revision of the accounting standard so that ‘only the most unusual’ events could be classified as abnormal (Saunders, 1999). In its 1999 financial reporting surveillance program, the Australian Securities and Investments Commission (ASIC)¹⁰ expressed concern that there was a lack of information about the nature of items disclosed as abnormal, that

⁸ The Australian accounting standard AASB 1031 *Materiality* states: “The notion of materiality influences whether an item or an aggregate of items is required to be recognised, measured or disclosed in accordance with the requirements of an Australian Accounting Standard” (para 10); and that the size and nature of the items usually need to be evaluated together (para. 12). Whilst paragraph 15 provides quantitative thresholds (<5% not material; >10% material) AASB 1031 prefaces these by stating “Materiality is a matter of professional judgement” (para. 15). AASB 1031 does not refer to amounts falling in the band between 5% and 10%, hence managerial discretion determines how items in this band are reported in financial statements.

⁹ An alternative explanation for immaterial items being reported as abnormal is that the nature of the items rather than their size may have a material effect on financial report users’ decisions. Similar to special/exceptional items in the U.S. /U.K. being considered as transitory in nature, managers of Australian firms may have classified earnings as abnormal items to signal to financial statement users the transitory nature of those abnormal items. Nevertheless, such immaterial items do not meet the AASB 1018 definition of abnormal items as that standard required items to be classified abnormal based on their size; the definition does not extend to the nature of the item.

¹⁰ The ASIC is the Australian regulator of public companies.

‘normal’ operating expenses were being classified as abnormal to boost pre-abnormal earnings, and that mining exploration companies were disclosing all write-offs of exploration expenditure as abnormal (McCahey, 1999: 72). These criticisms suggest that firms were opportunistically classifying items as ‘abnormal’ to influence financial statement users’ perceptions of their earnings.

In the 1999 revision to AASB 1018¹¹ the abnormal items classification was removed from the Accounting standards and instead, generally required disclosure of any item that was ‘of such a size, nature or incidence that its disclosure is relevant in explaining the financial performance of the entity’ (AASB 1018 para. 5.4).¹² As there was no explicit prohibition on the use of the term ‘abnormal item’, some entities continued to use the term when reporting their results to the market. The ASIC surveillance of 2001 financial reports identified that companies were still highlighting abnormal items. ASIC Chief Accountant, Ian Mackintosh, commented ‘some companies could not kick the abnormal habit and singled out ‘abnormal’ or ‘unusual’ items in the Statement of Financial Performance itself’ (Mackintosh, 2002: 49). Observations of companies continuing to label items as ‘abnormal’ or ‘significant’ in financial reports were also identified in the financial press.¹³

The persistence by companies of disclosing not only material but also immaterial items of revenue and expense as ‘abnormal’, significant’ or ‘unusual’ raises the issue of whether the standard setters were justified in removing the ‘abnormal’ classification from the accounting standard, and whether companies were opportunistically classifying items as abnormal prior to the accounting standard changes.

3. Prior research and hypothesis development

U.S. studies find that earnings classified as special items are asymmetric with a bias towards negative special items and that they are used to manage reported earnings to earnings benchmarks. These benchmarks include the use of special items: to manage earnings to avoid reporting an earnings decrease (DeFond & Park, 1997; Kinney &

¹¹ AASB 1018 was reissued in October 1999 as the *Statement of Financial Performance* and became operative for half-years ending on or after 31 December 2000 and for financial years ending on or after 30 June 2001.

¹² The disclosure requirements in AASB 1018 were subsequently superseded by AASB 101, effective 1 January 2005. AASB 101 is similar to AASB 1018 in its requirement to separately disclose material items; AASB 101, para. 86 states: “when items of income and expense are material, their nature and amount shall be disclosed separately.”

¹³ Examples include: “companies have allocated abnormals exactly as they used to, but have substituted new names” (Wilson, 2002: 24); and “until 2000, asset writedowns could be reported separately, as abnormal items. They are now called ‘significant items’” (Dunn, 2002: 34).

Trezevant, 1997); to manage earnings to avoid reporting a loss (Dechow, Richardson & Tuna, 2003); and to manage earnings to meet/beat analysts' earnings forecasts (Dechow et al., 2003). Evidence is also provided of special items being used for 'classification shifting' (McVay, 2006: 501) within the income statement by classifying core expenses as special items, thereby increasing core earnings. U.K. research finds that exceptional items were used for classificatory smoothing (Athanasakou et al., 2007) and that larger UK firms are more likely to engage in classification shifting, rather than accruals management, to avoid negative earnings surprises (Athanasakou et al., 2009).

3.1 Abnormal Items and Earnings Levels

DeFond and Park (1997) provide evidence of firms managing current period earnings through the use of discretionary accruals to increase or decrease reported earnings, depending of whether earnings are high or low. Similarly, Kinney and Trezevant (1997) present evidence consistent with special items being used to manage reported earnings. They argue that as the end of the financial reporting period approaches, managers identify special items that could be recognised should the level of pre-managed earnings before special items be higher/lower than the prior year's earnings. If management's estimate of earnings before special items is well above/below a pre-determined level, then management recognises income-decreasing/income-increasing special items. Alternatively, if earnings before special items is well below the pre-determined level, management recognises income-decreasing special items consistent with a big bath strategy.

McVay (2006) provides evidence of core operating expenses being classified as special items, where results for her sample firms show that approximately 2.2% of reported special items are, on average, part of the current period's 'core' earnings, thereby increasing the current period's reported core earnings. Athanasakou et al.'s (2007) U.K. findings show an increase in classificatory smoothing using exceptional items post-FRS3.

In line with the findings from the U.S. and U.K. that special and exceptional items can be used to manage earnings, abnormal items could have been similarly used to manage earnings in Australia. While the superseded accounting standard AASB 1018 required abnormally large earnings items to be classified as 'abnormal' and separately disclosed, managers had considerable discretion in determining whether the size of a revenue or expense transaction met the definition of an abnormal item. For example where a firm's

earnings before abnormal items (before manipulation) were below analysts' forecasts, an expense item within earnings before abnormal items could have been re-classified as an abnormal item, thereby increasing earnings before abnormal items to a given target. Alternatively, if pre-managed earnings before abnormal items were higher than the desired level, a revenue item could have been classified as abnormal, thus decreasing pre-abnormal earnings. Given that firms have different incentives to manage earnings and that both expense and revenue items could have been reclassified as abnormal to manage earnings, no direction is predicted for the association between abnormal items and pre-abnormal earnings. It is hypothesised:

H1a: Prior to 2001, the level of earnings before abnormal items is associated with whether firms reported abnormal items in that reporting period.

H1b: For firms that reported abnormal items, the level of earnings before abnormal items is associated with the amount of reported abnormal items in that reporting period.

3.2 Abnormal Items and Earnings Changes

Just as profit firms versus loss firms have different characteristics and therefore different incentives to manage earnings, the sign of the change in earnings could also be a determining factor in earnings management decisions. In addition to the sign of the change, the magnitude of the change in a firm's reported earnings from one period to the next is likely to influence whether managers engage in earnings management to manipulate reported earnings for the current and future periods. For example, Kinney and Trezevant (1997) provide evidence of managers recognising special items to mitigate the magnitude of the inter-period change in earnings.

Godfrey and Jones (1999) suggest that stable but steadily increasing earnings are likely to enhance managers' job security. Thus, managers will seek to smooth reported income by boosting earnings in poor earnings years while in good performance years they 'save' to boost earnings in future poorer years. While DeFond and Park (1997: 118) argue that a firm's current period performance and expected future period performance relative to industry averages are the relevant motivating factors for managers to smooth income, they acknowledge that 'within-firm longitudinal relative performance' is an alternative explanation. Similar to U.S. findings that firms reported special items to

move current year earnings closer to prior year's earnings to achieve steady growth in earnings (see Kinney & Trezevant, 1997), Australian firms may have re-classified items as abnormal to shift them from pre-abnormal earnings and thus mitigate the change in pre-abnormal earnings between the current and the prior period. Therefore, it is hypothesised:

H2a: Prior to 2001, the change in earnings before abnormal items is associated with whether firms reported abnormal items in that reporting period.

H2b: For firms that reported abnormal items, the change in earnings before abnormal items is associated with the amount of reported abnormal items in that reporting period.

3.3 Analyst Following and Analyst Forecasts

Analysts' forecasts have become increasingly important as a benchmark for assessing firms' performance, with the following of companies' securities by financial analysts viewed as having a strong effect on investors' perceptions and the market valuation of firms followed (Matsumoto, 2002). The prominence of earnings information to investors' evaluation of a firm's performance makes the forecasting of corporate earnings an essential product to the investing community (Beaver, 1998), creating incentives for firms to maintain analyst following. Empirical evidence presented by Myers, Myers and Skinner (2007) indicates that firms benefit from earnings management by a greater analyst following, fewer revisions and lower dispersion of analysts' forecasts, and a reduction in the magnitude and likelihood of earnings surprises.

Shareholders also benefit when analysts' forecasts are met. Kasznik and McNichols (1999) found that firms that consistently meet earnings expectations benefit by way of a valuation premium, and that companies that meet or beat earnings expectations report higher earnings in future periods. Bartov, Givoly & Hayn, (2002) and Lopez and Rees (2002) report that investors reward firms whose earnings meet or beat analysts' forecasts with a higher average quarterly return than firms that fail to meet forecasts.

Lopez and Rees (2002) conclude their evidence is consistent with the notion that market incentives motivate managers to manage earnings so as to consistently meet or beat analysts' forecasts.

Dechow et al. (2003) find that firms report an unusual level of special items when firms are minimising losses and for firms avoiding forecast errors. Documented evidence is consistent with companies using special/exceptional items to manage their earnings to meet analysts' forecasts, (Athanasakou et al., 2009; Kasznik & McNichols, 1999) and that firms that consistently meet earnings forecasts benefit by way of a valuation premium (Kasznik & McNichols, 1999), thereby providing incentives for firms to manage earnings to meet or beat forecasts. Furthermore, avoiding negative earnings surprises appears to dominate as an incentive over avoiding reporting of losses and earnings decreases (Brown & Caylor, 2005).

In Australia, financial analysts focused on earnings before abnormal items when evaluating firms' performance (Saunders, 1999). Furthermore, it was reported that even though 'abnormal items' had been removed from Australian accounting standards, financial analysts would continue to run models using pre-abnormal earnings as pre-abnormal earnings represented recurring earnings (Schulze, 2001). Firms with analyst following therefore have greater incentives to manage their reported pre-abnormal earnings by classifying items as abnormal. Thus it could be expected that firms that have analyst following are more likely to report abnormal items than firms not followed by analysts. Analyst following is also likely to have explained the relatively high incidence of firms that disclosed pre-abnormal earnings per share,¹⁴ and motivated firms to align earnings before abnormal items to analysts' forecasts. As share prices adjust to information conveyed in analysts' forecasts, managers may be motivated to ensure that those analysts' forecasts and reported earnings are aligned.

Abnormal items could have been used to manage reported earnings before abnormal items to minimise deviations between reported earnings and analysts' forecasts, thereby minimising analyst forecast errors. It is expected that firms with analyst following were

¹⁴ AASB 1027 (as applying during the study period from 1994 to 2000) did not require disclosure of earnings per share (EPS) excluding abnormal items. However, in addition to reporting EPS including abnormal items as required by AASB 1027, many firms voluntarily disclosed EPS excluding abnormal items as a measure of the firm's performance. Of the 59 sample firms used in Cameron and Gally's (2001) study, 22 (37%) voluntarily disclosed EPS excluding abnormal items in addition to the requirements of the operative AASB 1027.

more likely to have reported abnormal items, and for those firms with an analyst following, the amount of abnormal items was associated with analyst forecast errors. Therefore, it is hypothesised:

H3a: Prior to 2001, firms with analyst following were more likely to report abnormal items.

H3b: For firms with analyst following, firms reporting abnormal items were likely to meet/beat analysts' forecasts.

H3c: For firms that reported abnormal items, the amount of abnormal items is associated with whether the firm had an analyst following.

H3d: For firms that reported abnormal items and with analyst following, the amount of abnormal items is associated with whether analysts' forecasts were met.

4. Research Method

The study period extends over seven years from 1994 to 2000, as 2000 was the last year in which AASB 1018 prescribed disclosure of abnormal items, and financial data availability was limited for years prior to 1994. The sample was also limited to the top-500 Australian public companies (ranked by market capitalisation), due to data availability constraints. Financial statement data for sample firms were hand-collected from the *ASX FinData*, *Aspect* and *Connect 4* databases, and share price data was sourced from the *Datastream* database. After excluding observations with missing data, foreign domiciled firms and trusts, the final sample comprises 416 companies and 2,177 firm-year observations. Analysts' forecasts were sourced from the 'I/B/E/S' International Consensus Forecasts file. Of the full sample of 2177 firm-years, 910 had analysts' forecasts, of which 513 firm-years reported abnormal items.

We predict associations between whether a firm reported abnormal items and the level of current period earnings (H1a), the change between current and prior year pre-abnormal earnings (H2a) and analyst following (H3a). Logistic regression Model 1 is estimated to test for these associations, together with controls for size, industry, audit quality and loss firms.

$$\begin{aligned} \text{PRAIT}_{it} = & a_0 + a_1\text{EBAI}_{it} + a_2|\Delta\text{EBAI}|_{it} + a_3\Delta\text{EBAI_SIGN}_{it} + a_4\text{FC_D}_{it} + a_5\text{SIZE}_{it} \\ & + a_6\text{IND}_{it} + a_7\text{AUD}_{it} + a_8\text{PROF/LOSS}_{it} + \epsilon_{it} \end{aligned} \quad (1)$$

PRAIT represents the incidence of abnormal items and is coded one for firm-years reporting abnormal items, and zero otherwise. Earnings before abnormal items (*EBAI*) is measured as earnings after income tax and before abnormal items, scaled by beginning-of-the-year market capitalisation. Earnings change is represented by two variables to separately capture the magnitude of the change and the direction of the change. The magnitude of the change variable is the absolute value of the change in earnings before abnormal items (*|ΔEBAI|*) and is measured as the change between earnings before abnormal items for firm-year_{t-1} and earnings before abnormal items for firm-year_{t0}, scaled by beginning-of-the-year market capitalisation. The direction of earnings change variable (*ΔEBAI_SIGN*) is coded one where the change between earnings before abnormal items for firm-year_{t-1} and earnings before abnormal items for firm-year_{t0} is positive, and zero otherwise. *FC_D* is a dichotomous variable where firm-years with analyst following are coded one, and zero otherwise.

To control for firm-specific factors that may be associated with reporting abnormal items, four control variables are included in regression models. To control for the differing incentives that large firms have compared to small firms to manage earnings, the variable *SIZE* is included and measured as the natural logarithm of balance date total assets. As mining firms may have different financial profiles from other listed firms (Carey & Simnett, 2006), and given that mining firms were singled out by ASIC in their annual report surveillance for classifying write-offs as abnormal items, the variable *IND* controls for differing incentives faced by mining firms, coded one for mining firms and zero otherwise. *AUD* is a dichotomous variable and controls for the influence of audit quality with Big-6 auditors¹⁵ coded one and zero otherwise. To control for the differing incentives of profit versus loss firms, the variable *PROF/LOSS* is included, where profit (before abnormal items) firm-years are coded one and loss (before abnormal items) firm-years coded zero. To control for economy-wide effects that could influence the reporting of abnormal items year dummy variables are included in regression models. For firms with analyst following, H3b predicts an association between whether firms reported abnormal items and whether analysts' forecasts are met. Accordingly, *FC_Met* enters Model 2.

¹⁵The Big-6 auditors are Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers or its predecessor firms, Price Waterhouse and Coopers & Lybrand.

$$PRAIT_{it} = a_0 + a_1EBAI_{it} + a_2|\Delta EBAI|_{it} + a_3\Delta EBAI_SIGN_{it} + a_4FC_Met_{it} + a_5ANALYST_N_{it} + a_6SIZE_{it} + a_7IND_{it} + a_8AUD_{it} + a_9PROF/LOSS_{it} + \epsilon_{it} \quad (2)$$

FC_Met is a dichotomous variable coded one for firms that met/beat the earnings forecast, and zero for firms that missed the earnings forecast. The forecast error is measured as the difference between earnings before abnormal items and the earnings forecast (Bartov et al., 2002). Just as the presence of an analyst forecast may influence the reporting an abnormal item, the number of analysts following a firm may also influence the reporting of abnormal items. The greater the number of analysts the “greater the degree of scrutiny”¹⁶, providing incentives to report abnormal items to align earnings with forecasts. To control for this factor *ANALYST_N* enters Model 2 and is measured as the number of analysts following the firm in the relevant year. All other variables in Model 2 are the same as Model 1.

For firms that report abnormal items, we predict associations between the amount of abnormal items and the level of current period earnings before abnormal items (H1b), the change between current and prior year earnings before abnormal items (H2b), and analyst following (H3c). Regression Model 3 is estimated to test for these associations, together with the same control variables as in Model 1.

$$TAI_{it} = a_0 + a_1EBAI_{it} + a_2|\Delta EBAI|_{it} + a_3\Delta EBAI_SIGN_{it} + a_4FC_D_{it} + a_5SIZE_{it} + a_6IND_{it} + a_7AUD_{it} + a_8PROF/LOSS_{it} + \epsilon_{it} \quad (3)$$

TAI is the net aggregate amount of abnormal items¹⁷ reported by sample firms in year *t*, scaled by beginning-of-the-year market capitalisation.

Model 4 tests the H3d prediction that for those firms that report abnormal items and have analyst following, the amount of abnormal items is associated with whether analysts’ forecasts are met.

$$TAI_{it} = a_0 + a_1EBAI_{it} + a_2|\Delta EBAI|_{it} + a_3\Delta EBAI_SIGN_{it} + a_4FC_Met_{it} + a_5ANALYST_N_{it} + a_6SIZE_{it} + a_7IND_{it} + a_8AUD_{it} + a_9PROF/LOSS_{it} + \epsilon_{it} \quad (4)$$

5. Results

¹⁶ We thank an anonymous referee for this suggestion.

¹⁷ Firms could report multiple abnormal items in a given year, of which they may be all income-increasing, all income-decreasing or a combination of income-increasing and income-decreasing abnormal items. *TAI* therefore represents the net total amount of abnormal items reported in the given firm-year.

5.1 Descriptive statistics and univariate analysis

Table 2 presents summary descriptive statistics¹⁸ for the study variables with statistics for the continuous variables for firm-years with abnormal items presented in Panel A, and firm-years with no abnormal items in Panel B. Consistent with findings of U.S. research where the magnitude of income-decreasing special items exceeds that of income-increasing special items and with prior research using Australian data (Cameron & Gallery, 2008), Panel A shows that both the mean (−0.035) and median (−0.007) reported abnormal items are negative. Panel C reports results of tests of differences between the means for the independent variables and indicate that firms with abnormal items have a larger analyst following (*ANALYST_N*, $t = -6.007$, $p < 0.01$) and tend to be larger (*SIZE*) than firms with no abnormal items ($t = -3.529$, $p < 0.01$). The net income (*NI*) of firms with no abnormal items tends to be higher than both net income (*NI*) and earnings before abnormal items (*EBAI*) of firms that report abnormal items ($t = 10.342$, $p < 0.01$ and $t = 7.880$, $p < 0.01$, respectively). The negative change in *NI* for firms with no abnormal items and the change in earnings before abnormal items ($\Delta EBAI$) for those with abnormal items is not significantly different. However, the change in net income (ΔNI) between the two samples shows that firms with abnormal items experience a larger negative change in bottom line net income (mean = −0.021) than firms with no abnormal items (mean = −0.003). This difference is statistically significant ($t = 2.167$, $p < 0.05$) and reflects the larger than average negative impact of abnormal items on the bottom line.

[TABLE 2 HERE]

Table 3 shows the frequencies of the dichotomous variables for the two groupings of firm-years that reported abnormal items or had no abnormal items. The direction of the earnings change between the two samples is not significant. However, a higher proportion of firm-years reporting abnormal items had an analyst following (44.2%), compared to 39% (397) of firm-years that did not report abnormal items. This difference is statistically significant ($\chi^2 = 5.77$, $p < 0.05$), providing preliminary evidence that firms with analysts following were more likely to report abnormal items. Firm-years reporting

¹⁸ To mitigate the influence of outliers, extreme values were winsorised. As recommended by Tabachnick & Fidell (2001) this process was limited to 5% of the observations for each variable. A logarithmic transformation was effective in correcting the distribution of the variable *SIZE*. For robustness, statistical tests are run with outliers deleted from the sample to ensure results do not hinge on either of the 2 design choices in regard to winsorising as opposed to deletion of outliers. Statistical tests performed on the sample after deleting outliers yield consistent results.

abnormal items were less likely to meet or beat analysts' forecasts (55.4%) compared with those with no abnormal items (65.2%) ($\chi^2 = 9.08$, $p < 0.01$). A higher proportion of firms with abnormal items are mining firms (27.7%) than those with no abnormal items (20.6%). Those with abnormal items are also less likely to be audited by a Big-6 auditor (73.9% compared with 79.4%), and less likely to have reported a profit (76.7% compared with 86.4%). Overall, these results indicate that there are systematic differences between firms with and without abnormal items, on a univariate basis.

[TABLE 3 HERE]

A bivariate correlation matrix for all variables included in the regression models is presented in Table 4, Panel A for the full sample of firm-years ($n = 2177$) and in Panel B for the firms reporting abnormal items ($n = 1160$). All correlations among the independent variables are below acceptable conventional levels and therefore collinearity does not appear to pose a threat to the interpretation of regression coefficients of the independent variables.

[TABLE 4 HERE]

All the correlations between whether the firm reported abnormal items (*PRAIT*) and the independent variables shown in Table 4, Panel A, are consistent with the other univariate results reported for Tables 2 and 3. For the sub-sample of firms that reported abnormal items (Panel B of Table 4), correlations between the amount of abnormal items (*TAI*) and the test variables show that earning before abnormal items *EBAI* ($r = 0.163$; $p < 0.01$), the earnings change $|\Delta EBAI|$ ($r = -0.159$; $p < 0.01$) and analyst following (*FC_D*) ($r = 0.049$; $p < 0.10$) are associated with the amount of abnormal items. However, no significant association is found between *TAI* and the sign of the earnings change ($\Delta EBAI_SIGN$), or whether analysts' forecasts were met/beaten (*FC_Met*). From these results it appears that analyst following was a determinant of both the reporting of and magnitude of abnormal items. .

5.2 Multivariate Analysis

Table 5 reports the logistic regression results for tests of Model (1) for the full sample, and Model (2) for the sub-sample with analyst following; for comparative purposes, the third column reports results of logistic regression tests for the sub-sample with no analyst following. As found in the univariate tests, the regression results for the full sample suggest that firms that had lower levels of earnings before abnormal items were

more likely to report abnormal items (*EBAI*: $z = -4.681$, $p < 0.01$). While there is no significant association with the magnitude of the pre-abnormal earnings change ($|AEBAI|$), the direction of the change is positive and significant ($AEBAI_SIGN$: $z = 2.673$, $p < 0.01$), indicating that firms with an increase in pre-abnormal earnings from the previous year were more likely to report abnormal items. Firms with analyst following (FC_D : $z = 1.697$, $p < 0.10$) were also more likely to report abnormal items. These results provide support for H1a, H2a and H3a. Consistent with the univariate results, the significant positive coefficients for *SIZE* ($z = 5.568$, $p < 0.01$) and *IND* ($z = 2.294$, $p < 0.5$) indicate that larger firms and those in the mining industry were more likely to report abnormal items. Significant negative coefficients for *AUD* and *PROF/LOSS* ($z = -4.881$, $p < 0.01$ and $z = -2.920$, $p < 0.01$, respectively) indicate that firms reporting abnormal items were less likely to be audited by a Big 6 audit firm, and more likely to be a loss-firm.

Columns (2) and (3) of Table 5 presents regression test results of Model 2 for the two sub-samples of firms with analyst following and firms with no analyst following respectively. The results of Model (2) for both sub-samples (columns 2 and 3) for the test variables *EBAI* and $|AEBAI|$ are consistent with the full sample. For the sub-sample of firm-years with analyst following the positive coefficient for $AEBAI_SIGN$ ($z = 2.197$, $p < 0.05$) and negative coefficient for FC_Met ($z = -1.853$, $p < 0.10$), suggests that firms with a positive change in pre-abnormal earnings levels and those that achieved analysts' forecasts were less likely to report abnormal items. The positive coefficient for the control variable *ANALYST_N* suggests the greater the number of analysts following a firm the more likely the firm is to report an abnormal item. Results for the remaining control variables for both sub-samples are similar to the full sample.

[TABLE 5 HERE]

Table 6 presents the results of tests of Model (3) for all firms with abnormal items, and Model (4) for firms with abnormal items and analyst following, where the dependent variable in both models is the amount of abnormal items (*TAI*).¹⁹ For all firms (Table 6,

¹⁹ Multicollinearity of the variables was assessed using the measures of Tolerance and Variance Inflation Factor. Results of both these tests (not tabulated) shows that all variables are well within the accepted thresholds indicating there were no multicollinearity problems. To ensure that the results for the pooled regression results are not affected by autocorrelation in the data a Lagrange Multiplier (LM) test was conducted to determine whether the panel data should be tested using the classic regression model or a fixed/random effects model (Greene, 2003). The result of the LM test for several of the sub-samples is significant, indicating that the random effects model should be used. The random effects model was run for those sub-samples and as the results are qualitatively the same as the classical

Column 1), the coefficient for earnings level (*EBAI*) and analyst following (*FC_D*) is not statistically significant and therefore H1b and H3c are rejected. The negative and significant coefficient for the magnitude of earnings change ($|ΔEBAI|$; $t = -4.023$; $p < 0.01$) and non-significant coefficient for direction of the earnings change ($ΔEBAI_SIGN$) suggests that firms reporting larger amounts of abnormal items, on average, had smaller changes in pre-abnormal earnings, irrespective of the sign of the earnings change (higher or lower than the prior year). This result provides support for H2b, indicating that firms may have reclassified revenue and expense items as abnormal to shift them from pre-abnormal earnings and thus mitigate the magnitude of the pre-abnormal earnings change. The significant positive coefficient for *PROF/LOSS* ($t = 3.695$ $p < 0.01$) suggests that profit firms were more likely to report larger amounts of abnormal gains, and loss firms more likely to report large abnormal losses.

[TABLE 6 HERE]

Hayn (1995) argues that earnings management incentives differ between firms depending on differences in their economic characteristics. Thus firms may have competing incentives to report abnormal gains and abnormal losses, depending on the earnings level of the firm (profit or loss) and the direction of the earnings change (increase or decrease). To explore effects of differing reporting incentives, Model (3) is retested on the sub-samples of firms reporting abnormal gains and abnormal losses; the results are presented in Columns 2 and 3 of Table 6. Partitioning the sample significantly improves the explanatory power of Model (3), with the adjusted R^2 increasing from 7.2% for the overall sample, to 25.3% for the abnormal gains sub-sample and 16.9% for the abnormal loss sub-sample.

The results in Column 2 show that firms reporting larger amounts of abnormal gains have higher pre-abnormal earnings (*EBAI*; $t = 1.692$; $p < 0.10$) and tend to have larger changes in pre-abnormal earnings ($|ΔEBAI|$; $t = 7.169$; $p < 0.01$). This could reflect the shifting of gains from pre-abnormal earnings to abnormal gains to reduce reported pre-abnormal earnings for the current year and the benchmark earnings for the following year. The significant negative coefficient for *FC_D* ($t = -1.887$; $p < 0.10$) suggests that firms with an analyst following were more likely to report lower abnormal gains, given

regressions model, only the classical regression model results are reported. The absence of serial correlation in the data was also confirmed by Durbin-Watson tests for the full sample.

that *TAI* is on average negative. Firms with larger amounts of abnormal gains also tend to be smaller (*SIZE*; $t = -2.403$; $p < 0.01$), more likely to have made a loss (*PROF/LOSS*; $t = -2.992$, $p < 0.01$), and firms that were audited by a Big-6 auditor (*AUD*; $t = 2.807$, $p < 0.01$).

The results for firms reporting abnormal losses (Column 3) show a significantly negative coefficient for the magnitude of the change in pre-abnormal earnings ($|\Delta EBAI|$; $t = -7.201$; $p < 0.01$), suggesting that firms reporting larger amounts of abnormal losses tended to have smaller changes in pre-abnormal earnings. This finding again indicates that firms may have reclassified normal expense items as abnormal losses to dampen changes in pre-abnormal earnings.

Results for Model (4) are reported in columns (4), (5) and (6) of Table 6. For all firms with an analyst following (Column 4) and each of the subsamples of firms reporting abnormal gains and losses (columns 5 and 6, respectively), the coefficient for whether analysts' forecasts were met (*FC_Met*) is not statistically significant, and therefore H3d is rejected. Unlike Model 2, the control variable *ANALYST_N* is not significant indicating that the number of analysts following the firm is not associated with the magnitude of reported abnormal items. Results for the other test variables and controls are generally consistent with the results for all firms, except that in relation to the magnitude of earnings change ($|\Delta EBAI|$), the coefficient for firms with abnormal gains is not significant, whereas for those with abnormal losses, $|\Delta EBAI|$ is significantly negative ($t = -2.812$, $p < 0.01$). Thus, firms with analyst following and smaller earnings changes, on average, reported larger amounts of abnormal losses. Again, this result is consistent with firms reclassifying expense items as abnormal losses to mitigate inter-period changes in pre-abnormal earnings.

Taken together, the results reported in Table 6 suggest that the magnitude of earnings changes dominated as an earnings benchmark and incentive to reclassify income and expense items as abnormal. Those firms also tended to be loss firms. Also, firms in the mining industry tended to report more abnormal losses.

6. Conclusion

Unlike other jurisdictions, prior to 2001 Australian accounting standards permitted (and encouraged) presentation of a separate 'earnings before abnormal items' line item on the

face of the income statement. This mandatory requirement to classify and disclose items as ‘abnormal’ provides a unique setting to investigate intra-period classificatory earnings management.

Based on a sample of top-500 firms for the period 1994 to 2000, we investigate whether firms classified items as abnormal to meet the common earnings benchmarks that have been reported in the literature as creating incentives for firms to manage earnings: earnings levels, inter-period earnings changes and analysts’ forecasts. Whether there are differences in reporting of abnormal items for firms with and without analyst following is also examined. Overall, the evidence supports our predictions, indicating that firms reporting abnormal items were more likely to have lower levels of earnings, positive changes in earnings and analyst following, than firms with no reported abnormal items. For the sample of firms with abnormal items, it was found that the magnitude of earnings changes was consistently associated with amounts of abnormal items, suggesting that revenue and expense items may have been reclassified as abnormal to mitigate the magnitude of changes in pre-abnormal earnings. Further, the full sample of firms has, on average, reported abnormal losses thereby shifting losses from pre-abnormal earnings to bottom-line net income. This reclassification strategy which enhanced earnings before abnormal items was the earnings performance measure typically focused on by analysts and other market participants when abnormal items disclosures were mandated by Australian accounting standards.

These findings suggest that the standard setters were justified in removing the ‘abnormal’ classification from the accounting standard. However, it cannot be assumed that all firms acted opportunistically in the classification of items as abnormal. As Macleay (1999: 32) stated, the abnormal items classification allowed ‘an investor to determine the maintainable earnings of a company’ enabling a more informed decision in regard to investors buy/sell decisions on the basis of firms’ future profitability. With the removal of the standardised classification of items outside normal operations as ‘abnormal’, firms lost the opportunity to use such disclosures as a signalling device, with the consequential effect of limiting the scope of effectively communicating information about the nature of items presented in financial reports.

Since adopting international standards, Australian firms are required to disclose ‘material’ items of income and expense (IAS 1, paragraph 97), and are permitted additional sub-totals in the statement of comprehensive income (IAS 1, paragraph 85),

which might reflect earnings before the disclosed ‘material’ items. However, in the absence of a standardised classification of such items, there are likely to be inconsistencies between firms in how they present these items and increased uncertainty about whether the items are transitory, thus reducing the usefulness of such disclosures to users. The extent to which this is the case is an opportunity for further research.

The controversy on how components of earnings should be classified and disclosed continues. In the Discussion Paper *Preliminary Views on Financial Statement Presentation*, the FASB’s preliminary view is that ‘an entity should present information about unusual or infrequent events or transactions’ (para. 4.48) ‘so that managers can inform users about components within a line item ... that are less persistent and more subjective than the rest of the components in that line item.’ (para 4.50). This statement infers the need for a standardised and consistent approach to disclosure of such items. The IASB however, does not support the FASB view ‘because there is no notion of unusual or infrequent events or transactions in IFRSs’ (para 4.53). These markedly different positions of two powerful standard setting bodies suggests any resolution of these issues is likely to take some time to achieve.

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²⁰ This author's surname was incorrectly spelt as 'Horton' in the published article.

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	Note	Consolidated		Woolworths Limited	
		52 weeks ended 27 June 99 \$m	52 weeks ended 28 June 98 \$m	52 weeks ended 27 June 99 \$m	52 weeks ended 28 June 98 \$m
Revenue from operating activities	2	18,765.5	17,106.3	6,524.7	6,004.2
Revenue from outside the operating activities	2	159.9	175.6	212.3	140.8
Total Revenue		18,925.4	17,281.9	6,737.0	6,145.0
Earnings before interest, abnormal items and tax	3	539.4	516.2	395.7	345.5
Net finance costs	4	(45.5)	(42.8)	(45.2)	(43.0)
Operating profit before abnormal items and income tax		493.9	473.4	350.5	302.5
Abnormal items	5	(86.4)	(33.0)	(86.4)	(33.0)
Operating profit before income tax		407.5	440.4	264.1	269.5
Income tax expense	7	(150.2)	(160.8)	(35.0)	(44.7)
Operating profit after income tax		257.3	279.6	229.1	224.8
Outside equity interests in operating profit		(0.3)	(0.2)	-	-
Operating Profit Attributable to the Members of Woolworths Limited		257.0	279.4	229.1	224.8
Retained profits at beginning of the period		512.8	426.9	75.4	44.1
Dividends provided for or paid	8	(207.2)	(193.5)	(207.2)	(193.5)

Figure 1: Extract from Woolworths Ltd 1999 Annual Report

Table 1
Comparison of the Reporting Requirements for Earnings Akin to Abnormal Items
(as the standard applied during the study period) to International Jurisdictions

	U.S.	U.K.	Australia
Accounting Pronouncement	APB 30 <i>Reporting the Results of Operations</i>	FRS 3 <i>Reporting Financial Performance</i>	AASB 1018 <i>Profit and Loss Accounts</i>
	Unusual/Special Items	2 categories of Exceptional Items	Abnormal Items
Trigger	Material event or transaction unusual in nature or occur infrequently, but not both.	Material items that derive from events or transactions that fall within the entity's ordinary activities and need to be disclosed due to their size or incidence.	Earnings included in operating profit or loss which are considered abnormal by reason of their size & effect on the operating profit or loss.
Disclosure	Separate line item on the Income Statement or by way of note.	Category 1: On the face of the profit and loss, immediately below operating profit. Category 2: Reported under appropriate statutory format headings with separate disclosure in the notes.	On the face of the profit and loss statements or in the notes.
Examples Provided by the Standard Setters	Special items are not formally defined. Rather, Compustat determines the composition of special items. Compustat's definition of special items comprises items identified by Compustat from the income statement and the accompanying footnotes in the financial statements (and are reported by Compustat as data item number 32).	Category 1: - profit or loss on termination of an activity; - costs of a fundamental reorganisation; - profit or loss on disposal of fixed assets.	"major": - bad debt write-offs; - inventory write-downs; - write-offs of research & development expenses - depreciation adjustments; - gains and losses from the sale of investments or properties; - differences on movements in foreign currency exchange rates.
Prohibitions on Disclosure	Prohibits disclosure of sub-total for earnings before special items.	Prohibits disclosure of a sub-total for earnings before exceptional items.	None. Standard allowed disclosure of a sub-total for earnings before abnormal items and a total for earnings after abnormal items.

Table 2
Descriptive Statistics for Continuous Variables

Panel A: With Abnormal Items						
Variable	n	Mean	Median	Std Dev	Minimum	Maximum
<i>TAI</i>	1160	-0.035	-0.007	0.092	-0.318	0.091
<i>EBAI</i>	1160	0.054	0.063	0.112	-0.243	0.504
$\Delta EBAI$	1160	-0.008	-0.004	0.104	-0.350	0.328
$ \Delta EBAI $	1160	0.062	0.029	0.084	0.000	0.350
<i>NI</i>	1160	0.023	0.056	0.178	-0.473	0.505
ΔNI	1160	-0.021	-0.009	0.210	-0.623	0.567
<i>ANALYST_N</i>	513	8.860	9	4.768	1	19
<i>SIZE</i>	1160	12.320	12.021	2.069	6.580	19.660
Panel B: No Abnormal Items						
Variable	n	Mean	Median	Std Dev	Minimum	Maximum
<i>NI</i>	1017	0.092	0.078	0.135	-0.473	0.505
ΔNI	1017	-0.003	-0.003	0.168	-0.623	0.567
$ \Delta EBAI $	1017	0.072	0.035	0.091	0.000	0.350
<i>ANALYST_N</i>	397	7.010	6	4.472	1	20
<i>SIZE</i>	1017	12.026	11.752	1.818	6.790	19.350
Panel C: Tests of Differences- With Abnormal Items versus No Abnormal Items						
	t-statistic	MW z- statistic				
	(p value)	(p value)				
<i>NI - EBAI</i>	7.880	8.100				
	0.000	0.000				
<i>NI - NI</i>	10.342	10.080				
	0.000	0.000				
$\Delta NI - \Delta EBAI$	0.313	0.137				
	0.755	0.891				
$ \Delta EBAI - \Delta EBAI $	-2.624	-2.348				
	0.009	0.019				
$\Delta NI - \Delta NI$	2.167	2.461				
	0.030	0.014				
<i>ANALYST_N</i>	-6.007	-5.838				
	0.000	0.000				
<i>SIZE</i>	-3.529	-3.350				
	0.000	0.000				

TAI = Total abnormal items reported in year t , scaled by market capitalisation; **EBAI** = Earnings before abnormal items in year t , scaled by market capitalisation; $\Delta EBAI$ = Change between earnings before abnormal items for firm-year $_{t-1}$ and earnings before abnormal items firm-year $_{t0}$ scaled by market capitalisation; $|\Delta EBAI|$ = Change between earnings before abnormal items for firm-year $_{t-1}$ and earnings before abnormal items firm-year $_{t0}$ scaled by market capitalisation; **NI** = Net earnings for firm-year $_t$ scaled by market capitalisation; ΔNI = Change between net earnings for firm-year $_{t-1}$ and net earnings firm-year $_{t0}$ scaled by market capitalisation (0); **ANALYST_N** = The number of analysts following the firm in the relevant year; **SIZE** = The natural logarithm of total assets.

Table 3
Descriptive Statistics for Dichotomous variables

Variable	With an Abnormal Items				No Abnormal Items					
	0	%	1	%	0	%	1	%	χ^2	p-value
<i>ΔEBAI_SIGN</i>	634	54.7	526	45.3	562	55.3	455	44.7	0.080	0.796
<i>FC_D</i>	647	55.8	513	44.2	620	61.0	397	39.0	5.77	0.016
<i>FC_Met (n=910)</i>	229	44.6	284	55.4	138	34.8	259	65.2	9.08	0.003
<i>IND</i>	839	72.3	321	27.7	808	79.4	209	20.6	14.92	0.000
<i>AUD</i>	303	26.1	857	73.9	209	20.6	808	79.4	9.35	0.002
<i>PROF/LOSS (firms)</i>	270	23.3	890	76.7	138	13.6	879	86.4	33.53	0.000

ΔEBAI_SIGN = change between earnings before abnormal items for firm-year_{t-1} and earnings before abnormal items for firm-year_{t0} is positive (1) , otherwise (0); **FC_D** = Firm-years accompanied by an analyst forecast (1), otherwise (0); **FC_Met** = Met/beat analysts' forecast (1), otherwise (0); **IND** = Mining (1), Other (0); **AUD** = Big 6 Audit Firm (1), otherwise (0); **PROF/LOSS** = Firms reporting a profit before abnormal items (1), Firms reporting a loss before abnormal items (0).

Table 4
Pearson Correlation Coefficients and (two-tailed) p -values in Upper Right Diagonal and Spearman
Correlation Coefficients and (two-tailed) p -values in Lower Left Diagonal

Panel A: Full Sample (n=2177)											
	<i>PRAIT</i>	<i>EBAI</i>	$ \Delta EBAI $	$\Delta EBAI_SIGN$	<i>FC_D</i>	<i>FC_Met</i> (n=910)	<i>ANALYST_N</i>	<i>SIZE</i>	<i>IND</i>	<i>AUD</i>	<i>PROF/LOSS</i>
<i>PRAIT</i>	1	-0.168	-0.057	0.006	0.052	-0.100	0.087	0.075	0.083	-0.066	-0.124
		0.000	0.008	0.777	0.014	0.003	0.000	0.000	0.000	0.002	0.000
<i>EBAI</i>	-0.174	1	0.173	0.236	0.114	0.388	0.108	0.189	-0.230	-0.006	0.628
	0.000		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.787	0.000
$ \Delta EBAI $	-0.050	0.128	1	-0.012	-	0.094	-0.202	-0.232	0.011	-0.046	-0.171
					0.210						
$\Delta EBAI_SIGN$	0.019	0.000		0.589	0.000	0.005	0.000	0.000	0.620	0.032	0.000
	0.006	0.254	-0.049	1	0.000	0.182	-0.007	-0.023	0.018	0.000	0.127
	0.777	0.000	0.021		0.996	0.000	0.727	0.277	0.412	0.977	0.000
<i>FC_D</i>	0.052	0.131	-0.167	0.000	1		0.954	0.496	-0.053	0.182	0.276
	0.014	0.000	0.000	0.996			0.000	0.000	0.013	0.000	0.000
<i>FC_Met</i>	-0.100	0.477	0.064	0.182		1	0.034	0.099	-0.079	0.039	0.215
	0.003	0.000	0.052	0.000			0.312	0.003	0.017	0.236	0.000
<i>ANALYST_N</i>	0.087	0.108	-0.202	-0.007	0.954	0.034	1	0.658	0.005	0.216	0.254
	0.000	0.000	0.000	0.727	0.000	0.312		0.000	0.813	0.000	0.000
<i>SIZE</i>	0.076	0.212	-0.236	-0.021	0.538	0.101	0.623	1	-0.124	0.237	0.393
	0.000	0.000	0.000	0.317	0.000	0.002	0.000		0.000	0.000	0.000
<i>IND</i>	0.083	-0.308	0.035	0.018	-	-0.079	-0.027	-0.117	1	0.055	-0.265
					0.053						
	0.000	0.000	0.098	0.412	0.013	0.017	0.205	0.000		0.011	0.000
<i>AUD</i>	-0.066	-0.024	-0.033	0.000	0.182	0.039	0.209	0.250	0.055	1	0.070
	0.002	0.272	0.128	0.977	0.000	0.236	0.000	0.000	0.011		0.001
<i>PROF/LOSS</i>	-0.124	0.676	-0.144	0.127	0.276	0.215	0.281	0.407	-0.265	0.070	1
	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.001	

Panel B: Firm Years with Abnormal items (n=1160)											
	<i>TAI</i>	<i>EBAI</i>	$ \Delta EBAI $	$\Delta EBAI_SIGN$	<i>FC_D</i>	<i>FC_Met</i> (n=513)	<i>ANALYST_N</i>	<i>SIZE</i>	<i>IND</i>	<i>AUD</i>	<i>PROF/LOSS</i>
<i>TAI</i>	1	0.163	-0.159	0.044	0.049	0.060	0.088	0.125	-0.090	0.004	0.227
		0.000	0.000	0.133	0.098	0.173	0.003	0.000	0.002	0.904	0.000
<i>EBAI</i>	0.145	1	-0.039	0.259	0.185	0.391	0.142	0.300	-0.218	0.020	0.684
	0.000		0.189	0.000	0.000	0.000	0.000	0.000	0.000	0.492	0.000
$ \Delta EBAI $	-0.137	-	1	-0.030	-	0.057	-0.255	-0.257	0.011	-0.103	-0.249
		0.021			0.229						
	0.000	0.472		0.305	0.000	0.200	0.000	0.000	0.707	0.000	0.000
$\Delta EBAI_SIGN$	0.052	0.281	-0.078	1	0.005	0.216	-0.003	-0.006	-0.002	-0.010	0.182
	0.078	0.000	0.008		0.870	0.000	0.922	0.834	0.942	0.727	0.000
<i>FC_D</i>	-0.010	0.193	-0.198	0.005	1		0.811	0.528	-0.043	0.265	0.326
	0.724	0.000	0.000	0.870			0.000	0.000	0.148	0.000	0.000
<i>FC_Met</i>	0.080	0.476	0.046	0.216		1	0.079	0.125	-0.059	0.024	0.221
	0.072	0.000	0.303	0.000			0.074	0.005	0.185	0.582	0.000
<i>ANALYST_N</i>	0.017	0.181	-0.239	0.001	0.946	0.078	1	0.685	-0.020	0.295	0.317
	0.574	0.000	0.000	0.983	0.000	0.077		0.000	0.497	0.000	0.000
<i>SIZE</i>	0.082	0.320	-0.275	0.002	0.562	0.133	0.660	1	-0.015	0.317	0.328
	0.005	0.000	0.000	0.940	0.000	0.003	0.000		0.613	0.000	0.000
<i>IND</i>	-0.078	-	0.045	-0.002	-	-0.059	-0.033	-0.140	1	0.030	-0.270
		0.302			0.043						
	0.008	0.000	0.123	0.942	0.148	0.185	0.264	0.000		0.307	0.000
<i>AUD</i>	-0.037	0.011	-0.059	-0.010	0.265	0.024	0.294	0.317	0.030	1	0.104
	0.211	0.697	0.043	0.727	0.000	0.582	0.000	0.000	0.307		0.000
<i>PROF/LOSS</i>	0.182	0.732	-0.207	0.182	0.326	0.221	0.337	0.470	-0.270	0.104	1
	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	

PRAIT = Firm-years reporting an abnormal item (1), zero otherwise; **TAI** = Total abnormal items reported in year t , scaled by market capitalisation; $|\Delta EBAI|$ = Change between earnings before abnormal items for firm-year $_{t-1}$ and earnings before abnormal items firm-year $_{t0}$ scaled by market capitalisation; $\Delta EBAI_SIGN$ = change between earnings before abnormal items for firm-year $_{t-1}$ and earnings before abnormal items for firm-year $_{t0}$ is positive (1) , otherwise (0); **FC_D** = Firm-years accompanied by an analyst forecast (1), otherwise (0); **FC_Met** = Met/beat analysts' forecast (1), otherwise (0); **ANALYST_N** = The number of analysts following the firm in the relevant year; **SIZE** = The natural logarithm of total assets; **IND** = Mining (1), Other (0); **AUD** = Big 6 Audit Firm (1), otherwise (0); **PROF/LOSS** = Firms reporting a profit before abnormal items (1), Firms reporting a loss before abnormal items (0).

Table 5

Logistic Regression Analysis of the Variables Predicted to be Associated with Abnormal Items

$$\text{Model 1: } \text{PRAIT}_{it} = a_0 + a_1\text{EBAI}_{it} + a_2|\Delta\text{EBAI}|_{it} + a_3\Delta\text{EBAI_SIGN}_{it} + a_4\text{FC_D}_{it} + a_5\text{SIZE}_{it} + a_6\text{IND}_{it} + a_7\text{AUD}_{it} + a_8\text{PROF/LOSS}_{it} + \epsilon_{it}$$

$$\text{Model 2: } \text{PRAIT}_{it} = a_0 + a_1\text{EBAI}_{it} + a_2|\Delta\text{EBAI}|_{it} + a_3\Delta\text{EBAI_SIGN}_{it} + a_4\text{FC_Met}_{it} + a_5\text{ANALYST_N}_{it} + a_6\text{SIZE}_{it} + a_7\text{IND}_{it} + a_8\text{AUD}_{it} + a_9\text{PROF/LOSS}_{it} + \epsilon_{it}$$

	Model 1: Full Sample (1)	Model 2: With Analyst Following (2)	No Analyst Following (3)
	Coefficient z-statistic	Coefficient z-statistic	Coefficient z-statistic
EBAI	-2.588 -4.681 **	-1.953 -1.736 ^	-2.314 -3.514 **
 ΔEBAI 	-0.225 -0.382	-0.625 -0.441	-0.190 -0.291
ΔEBAI_SIGN	0.252 2.673 **	0.333 2.197 *	0.231 1.872 ^
FC_D	0.178 1.697 ^		
FC_Met		-0.292 -1.853 ^	
ANALYSTS_N		0.079 3.273 **	
SIZE	0.160 5.568 **	0.040 0.634	0.129 3.260 **
IND	0.251 2.294 *	0.355 1.930 ^	0.078 0.552
AUD	-0.537 -4.881 **	-0.094 -0.456	-0.741 -5.645 **
PROF/LOSS	-0.494 -2.920 **	-0.674 -1.796 ^	-0.550 -2.749 **
Constant	-1.028 -2.852 **	0.263 0.320	-0.625 -1.304
Year Dummies	Yes	Yes	Yes
N	2177	910	1267
Nagelkerke R ²	0.082	0.11	0.098
Wald χ ²	138.696	77.734	96.939
Sig	<0.01	<0.01	<0.01

^/ * / ** Significant at the 0.10 / 0.05 / 0.01 level (two tailed).

PRAIT = Firm-years reporting an abnormal item (1), zero otherwise; **EBAI** = Earnings before abnormal items in year t , scaled by market capitalisation; **|ΔEBAI|** = Change between earnings before abnormal items for firm-year _{$t-1$} and earnings before abnormal items firm-year _{t_0} scaled by market capitalisation; **ΔEBAI_SIGN** = change between earnings before abnormal items for firm-year _{$t-1$} and earnings before abnormal items for firm-year _{t_0} is positive (1), otherwise (0); **FC_D** = Firm-years accompanied by an analyst forecast (1), otherwise (0); **FC_Met** = Met/beat analysts' forecast (1), otherwise (0); **ANALYST_N** = The number of analysts following the firm in the relevant year; **SIZE** = The natural logarithm of total assets; **IND** = Mining (1), Other (0); **AUD** = Big 6 Audit Firm (1), otherwise (0); **PROF/LOSS** = Firms reporting a profit before abnormal items (1), Firms reporting a loss before abnormal items (0). Year dummy variables included to control for economy-wide effects.

Table 6

Regression Analysis of the Variables Predicted to be Associated with Abnormal Items

$$\text{Model 3: } TAI_{it} = a_0 + a_1 EBAI_{it} + a_2 |\Delta EBAI|_{it} + a_3 \Delta EBAI_SIGN_{it} + a_4 FC_D_{it} + a_5 SIZE_{it} + a_6 IND_{it} + a_7 AUD_{it} + a_8 PROF/LOSS_{it} + \epsilon_{it}$$

$$\text{Model 4: } TAI_{it} = a_0 + a_1 EBAI_{it} + a_2 |\Delta EBAI|_{it} + a_3 \Delta EBAI_SIGN_{it} + a_4 FC_Met_{it} + a_5 ANALYST_N_{it} + a_6 SIZE_{it} + a_7 IND_{it} + a_8 AUD_{it} + a_9 PROF/LOSS_{it} + \epsilon_{it}$$

	Model 3			Model 4 (With Analyst Following)		
	All Firms with AIs	Firms with AI Gains	Firms with AI Losses	All Firms with AIs	Firms with AI Gains	Firms with AI Losses
	(1) Coefficient t-stat	(2) Coefficient t-stat	(3) Coefficient t-stat	(4) Coefficient t-stat	(5) Coefficient t-stat	(6) Coefficient t-stat
<i>EBAI</i>	.020 .611	.031 1.692 ^	.048 1.196	.070 1.236	.037 1.035	.066 .921
<i> \Delta EBAI </i>	-.135 -4.023 **	.123 7.169 **	-.302 -7.201 **	-.194 -2.865 **	.061 1.349	-.235 -2.812 **
<i>\Delta EBAI_SIGN</i>	.000 -.013	.000 -.001	-.009 -1.306	-.008 -1.158	.012 3.005 **	-.014 -1.559
<i>FC_D</i>	-.008 -1.231	-.007 -1.887 ^	.006 .727			
<i>FC_Met</i>				.000 -.044	.001 .219	-.003 -.315
<i>ANALYSTS_N</i>				.001 .688	-.001 -1.294	.002 1.443
<i>SIZE</i>	.002 1.159	-.002 -2.403 *	.002 .890	.002 .740	.000 .243	.000 -.051
<i>IND</i>	-.008 -1.303	.000 -.095	-.018 -2.462 *	-.013 -1.646	.007 1.488	-.026 -2.619 **
<i>AUD</i>	-.007 -1.043	.009 2.807 **	-.001 -.171	-.003 -.250	.003 .459	-.005 -.404
<i>PROF/LOSS</i>	.035 3.695 **	-.016 -2.992 **	.035 3.112 **	.041 2.702 **	.003 .211	.029 1.594
Constant	-.076 -3.648 **	.054 4.725 **	-.109 -4.427 **	-.100 -2.762 **	.005 .217	-.090 -1.983 *
Year dummies included	YES	YES	YES	YES	YES	YES
N	1160	420	740	513	169	344
Adj R²	0.072	0.253	0.169	0.087	0.092	0.112
F-stat	7.463	11.156	11.766	4.255	2.137	3.885
Sig	<0.01	<0.01	<0.01	<0.01	<0.01	<0.01

^/ */ ** Significant at the 0.10 / 0.05 / 0.01 level (two tailed).

TAI = Total abnormal items reported in year t , scaled by market capitalisation; **EBAI** = Earnings before abnormal items in year t , scaled by market capitalisation; **|\Delta EBAI|** = Change between earnings before abnormal items for firm-year _{$t-1$} and earnings before abnormal items firm-year _{t_0} scaled by market capitalisation; **\Delta EBAI_SIGN** = change between earnings before abnormal items for firm-year _{$t-1$} and earnings before abnormal items for firm-year _{t_0} is positive (1), otherwise (0); **FC_D** = Firm-years accompanied by an analyst forecast (1), otherwise (0); **FC_Met** = Met/beat analysts' forecast (1), otherwise (0); **ANALYST_N** = The number of analysts following the firm in the relevant year; **SIZE** = The natural logarithm of total assets; **IND** = Mining (1), Other (0); **AUD** = Big 6 Audit Firm (1), otherwise (0); **PROF/LOSS** = Firms reporting a profit before abnormal items (1), Firms reporting a loss before abnormal items (0). Year dummy variables included to control for economy-wide effects.