

Signaling Firm Performance Through Financial Statement Presentation:**An Analysis Using Special Items**

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ABSTRACT: This paper investigates whether presentation of special items within the financial statements reflects the firm's underlying economic performance or opportunism. We examine the presentation of recognized special items either as a separate line item on the income statement or aggregated within another line item with disclosure only in the footnotes. Our study is motivated by standard-setting interest in performance reporting and financial statement presentation, as well as prior research investigating managers' presentation choices in other contexts. Using different constructs of persistence to capture the economics of reported special items, we find evidence consistent across a range of specifications that special items highlighted on the income statement are more transitory than those revealed only in the footnotes. For most special items, these results are consistent with this presentation decision reflecting underlying firm performance. For a subset observations – namely, those likely to reflect “big bath” reporting incentives – we provide limited evidence suggestive of opportunism in this presentation decision.

Keywords: *special items, strategic reporting, presentation, voluntary disclosure, pro forma*

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1. Introduction

This paper investigates managers' presentation of special items within the financial statements. Specifically, we examine the use of aggregation/disaggregation within the income statement as a mechanism to highlight special items. We test whether management's decision to present special items either as a separate line item on the income statement (income statement presentation) or aggregated into another line item with identification only via footnote disclosure (footnote presentation) reflects informational or opportunistic motivations. Under both presentation choices, the special item is recognized, i.e., reflected in net income. By informational, we suggest managers use income statement presentation as a mechanism to assist users in better identifying and understanding the firm's underlying performance. In our context, disaggregation of special items via income statement presentation is informational when those special items have different economic characteristics (lower persistence) than special items that are aggregated with other income statement items and only disclosed via footnote presentation. By opportunistic, we suggest managers use this presentation decision to influence perceptions of the firm's performance in a biased manner. In our context, we examine if managers choose to highlight special items on the income statement to portray more favorable benchmarks of the firm's performance.

Our study is motivated by academic interest in financial statement presentation, particularly that examining the aggregation of line items (e.g., Dye and Sridhar 2004) and the characteristics of permanent versus transitory components of earnings (e.g., Brooks and Buckmaster 1976; Elliott and Hanna 1996). These papers provide evidence that disaggregation of elements having differential implications for firm performance improves the information about the firm. In addition, our paper is motivated by standard-setter interest in performance reporting issues, which arises from the flexibility afforded managers in these presentation choices and the potential for these choices to affect users' analysis and decisions. This is evidenced in a joint project between the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) to establish common, high-quality standards for the presentation of information in financial statements (see FASB 2006 and IASB 2006). Consistent with this perspective, prior literature provides experimental evidence that financial statement presentation can affect users' judgments (e.g., Hirst and Hopkins 1998; Maines and McDaniel 2000). Our examination of disclosure choices regarding special items – which are typically described as “non-recurring” items – also provides insights relevant to other current and future financial reporting requirements likely to introduce similar non-recurring items (such as fair value accounting).

We choose the presentation of special items as our experimental setting for the following reasons. First, special items have been shown to have differing properties relative to other components of income (e.g., Lipe 1986), suggesting differing presentation in financial statements may be warranted. Second, they have been increasing, quite dramatically, in frequency and magnitude over time (e.g., Elliott and Hanna 1996; see also Appendix A), thus becoming a significant component of income for many firms. Third, they are heterogeneous across a number of characteristics (e.g., Francis, Hanna, and Vincent 1996; Burgstahler, Jiambalvo, and Shevlin 2002), providing cross-sectional variation that we exploit in our empirical examination. Finally, we conjecture that special items provide a strong setting for examining motivations underlying managers' financial statement presentation choices, as the reporting of special items typically reflects substantial inherent uncertainty (e.g., the success of a restructuring) and measurement error (e.g., estimation of impaired goodwill).

2. Prior Research, Motivation, and Hypothesis Development

Prior Research and Motivation

Prior literature on management disclosure (e.g., Healy and Palepu 2001) suggests that disclosure decisions reflect both informational motivations (that is, managers use these decisions to inform financial statement users about the underlying economics of their firms) and opportunistic motivations (that is, managers use these decisions to bias users' perspectives). In this study, we focus on management choice of presentation *within* the financial statements as a disclosure medium. Thus, we examine managers' choice to present separately (and therefore highlight) certain elements within the financial statements, a notion that relates to the literature on aggregation of performance measures (e.g., Dye and Sridhar 2004).

Prior research on disclosure choices to emphasize financial performance metrics has generally focused on alternative settings, particularly pro forma reporting. A number of papers provide evidence consistent with management reporting in this context reflecting opportunism. Schrand and Walther (2000) examines earnings press releases, and documents that managers are more likely to separately announce a prior-period gain from the sale of assets than a loss, consistent with managers opportunistically selecting the prior-period earnings amount used as a benchmark to evaluate current-period earnings. Weiss (2001) examines the reporting effects of the 1993 change in corporate income tax rates, and similarly finds that managers are more likely to separately disclose negative than positive non-recurring items in press releases, consistent with managers attempting to highlight the negative items as transitory or non-core expenses. McVay (2006) provides similar evidence, documenting that managers opportunistically shift reported expenses from core expenses (such as cost of goods sold) to special items, thereby overstating "core" earnings. In the current paper, we examine managers' direct presentation decisions within the financial statements, which have received scant empirical investigation. Prior experimental research in other financial statement presentation contexts (such as the reporting of comprehensive income) reveals that such presentation choices can affect the costs to users to identify, interpret, and weigh the implications of reported items for the firm (e.g., Hirst and Hopkins 1998; Maines and McDaniel 2000; Elliott 2006). Thus, similar to the literature on pro forma reporting, we examine a management presentation decision – i.e., the extent to which management chooses to highlight reporting elements within the financial statements.

As our setting, we focus on managers' presentation of special items. *Accounting*

Principles Board 30 – Reporting the Results of Operations defines special items as charges that are infrequent or unusual in nature.³ We choose special items as our setting for the following reasons. First, proper identification and labeling of this type of charge is likely relevant for financial statement users, as these items may have differing properties from other components of earnings (e.g., Lipe 1986; Fairfield, Sweeney, and Yohn 1996; Francis, Hanna, and Vincent 1996; Burgstahler, Jiambalvo, and Shevlin 2002). Second, special items have increased dramatically in frequency and magnitude over recent years (e.g., Elliott and Hanna 1996; our Appendix A). Further, special items represent reporting events where opportunities to inform or bias perceptions through presentation choice are likely exacerbated, owing to the high uncertainty (such as the success of a restructuring endeavor) and challenging measurement issues (such as estimating an impairment) that typically

surround special items. Finally, there are no rigid guidelines regarding the presentation of such items, except that they must be included in operating income. Thus,

managers have discretion over how special items are presented on the income statement.⁴ In particular, managers may present special items in one of two ways: as a separate line item on the income statement with possible discussion in the footnotes (i.e., *income statement presentation*), or aggregated within another line item on the income statement with identification and discussion of the special items only via the footnotes (i.e., *footnote presentation*). Again, in both cases the special items are recognized – i.e., reflected in net income. The choice is the extent to which management highlights these items on the face of the income statement.

3. Hypothesis Development

Applying the findings of prior research, we propose that management presentation of special items within the income statement reflects two notions. First, managers may use the presentation choice to provide users with information on the underlying economic characteristics of these items (i.e., informational motivations). In the context of special items, highlighting such charges via separate presentation on the income statement suggests that these items have differing properties, such as implications for future performance, than other income statement elements. However, because separate presentation can suggest different properties of the income statement item, managers may alternatively use the presentation choice to bias users' perceptions of performance (i.e., opportunistic motivations).. **Research Design**

Our research design employs two primary tests. First, we model the determinants of the presentation of special items. Second, we examine whether the persistence of special items varies across the presentation decision. Consistent with the above discussion, for both analyses we also separately examine “big bath” versus “non-big bath” observations to better identify special items where informational versus opportunistic motivations are more likely to occur.

5. Determinants of Financial Statement Presentation of Special Items

We use the following model to examine the determinants of management's presentation of special items separately on the income statement (income statement presentation) versus

aggregated into another line item with identification only via footnote disclosure (footnote presentation):

$$SI_Sep_{jt} = \delta_0 + \delta_1 YEAR_t + \delta_2 SIZE_{jt} + \delta_3 INST_{jt} + \delta_4 SI_MAG_{jt} + \delta_5 SI_PERSIST_{jt} + \delta_6 NSI_{jt} + \delta_7 MISS_PYE_{jt} + \delta_8 BEAT_PYE_{jt} + \varphi_{jt} \quad (1)$$

We estimate this model under two specifications. First, under an OLS specification, we define *SI_Sep* as the percentage of special items reported within a separate line item on the income statement for firm *j* in fiscal year *t*. This is measured as the absolute amount of special items identified in a separate line item on the income statement, divided by the absolute amount of total

reported special items; thus, the variable ranges in value from 0 to 1, inclusive. Note that positive (i.e., income-increasing) and negative (i.e., income-decreasing) special items are not netted in this calculation.⁶ Second, since our dependent variable has significant clustering at the end points of its distribution, we also examine a logistic specification. Here, we define *SI_Sep* as an indicator variable equal to 1 when any reported special items receive income statement presentation, and 0 when all reported special items receive footnote presentation. This is akin to suggesting that the highlighting of any special item serves as a “red flag” for users to look for other related items.

Our model includes four control variables. First, we include *YEAR* (the year) as the likelihood of presenting special items separately on the income statement may be changing over time; for example, pro forma reporting increased over our sample period (e.g., Bradshaw and Sloan 2002). Second, we include *SIZE* (the log of firm *j*'s year *t* sales) to control for differing investing and information environments across variously sized firms on the presentation decision.

Consistent with our previous discussion, we first apply Equation (1) to the full sample, and then separately to the sub-samples of “big bath” and “non-big bath” observations. We define “big bath” observations as those with all of the following characteristics: report net negative special items; report “large” negative special items (defined, consistent with prior research, as total negative special items exceeding 1% of lagged total assets – see Elliott and Shaw 1988, and Elliott and Hanna 1996); and that miss prior year's earnings due to the special item. Because “non-big bath” observations should be unaffected by “big bath” incentives to recognize special items, this sub-sample should provide the cleanest inferences regarding informational versus opportunistic motivations for the presentation decision.

items for year *t*. We use all available data from Compustat, estimating annual regressions for each 3-digit SIC industry, which will capture the economics of similar firms in similar time periods. Thus, *SI_PERSIST* reflects the observed coefficient on special items, i.e., the vector of the year-industry persistence parameters for special items.⁷

Recall that we wish to identify whether the presentation decision reflects informational versus opportunistic motivations, on average. Regarding *SI_PERSIST*, informational motivations would suggest that managers use income statement presentation to highlight those special items that are more transitory in nature, and footnote presentation for those special items that are more likely to having recurring (i.e., persistent) implications for firm performance. That is, disaggregation of special items via income statement presentation is informational when those special items have different economic characteristics (lower persistence) than special items that are aggregated with other income statement items and disclosed via footnote presentation. Thus, under informational motivations, we would expect the manager to provide income statement (footnote) presentation for those special items that are economically more transitory (persistent) in nature, leading to a predicted negative sign for δ_5 .

period core earnings.⁸ If managers wish to artificially inflate core earnings, they would provide income statement presentation for any special item that reduces net income, attempting to highlight these as transitory regardless of their economic content. Similarly, managers would provide footnote presentation for any special items that increase net income, attempting to designate these as persistent regardless of their economic content. That is, disaggregation of special items via income statement presentation is opportunistic when those special items have different economic characteristics (higher persistence) than special items that are aggregated with other income statement items and disclosed via footnote presentation. Thus, under opportunistic motivations, we would expect the manager to provide income statement (footnote) presentation for those special items that are economically more persistent (transitory) in nature, leading to a predicted positive sign for δ_5 .

Next, we argue that the effect of the special item on net income (i.e., whether it is a positive special item (PSI) or negative special item (NSI)) affects this presentation decision. Accordingly, we include *NSI*, an indicator variable equal to 1 if the firm has negative special items, and 0 otherwise.

6. Presentation of Special Items and Earnings Persistence

In the previous analysis, we measure persistence of the special items at an average (i.e., industry) level. We now alternatively employ the following analysis examining the presentation of special items and earnings persistence (similar to Burgstahler, Jiambalvo, and Shevlin 2002), which allows a more direct measure of firm-level persistence of reported special items:

$$E_{jt+1} = \alpha_0 + \alpha_1 E^*_{jt} + \alpha_2 SI_IS_{jt} + \alpha_3 SI_FN_{jt} + \gamma_{jt} \quad (2)$$

E_{jt+1} is earnings for firm j for year $t+1$. E^*_{jt} is earnings before special items for firm j for year t .

SI_IS_{jt} is special items receiving income statement presentation for firm j for year t . SI_FN_{jt} is

special items receiving footnote presentation firm j for year t . For this analysis we use signed

(versus absolute) special item amounts.¹⁰ All variables are scaled by market value of equity at the

beginning of year t . lysis examines the predictive content of current period earnings and special items for future (one-period ahead) earnings; thus, we again use an *ex post* measure of future performance to assess the economic content (that is, the persistence) of the reported special item. If managers correctly *ex ante* identify those special items that are economically more transitory, and emphasize them via income statement presentation, informational motivations predict $\alpha_2 < \alpha_3$. Alternatively, if managers use income statement presentation to highlight as transitory those special items that economically are more persistent, opportunistic motivations predict $\alpha_2 > \alpha_3$.

To again better disentangle the informational versus opportunistic motivations, we incorporate the “big bath” reporting incentive into Equation (2) by estimating the following:

$E_{jt+1} = \beta_0 + \beta_1 E^*_{jt} + \beta_2 SI_IS_{jt} + \beta_3 SI_FN_{jt} + \beta_4 SI_IS_BATH_{jt} + \beta_5 SI_FN_BATH_{jt} + \theta_{jt}$ (2a)
 SI_IS_BATH (SI_FN_BATH) are special items receiving income statement (footnote) presentation for those observations likely to reflect “big bath” reporting incentives. We define “big bath”

observations as in Equation (1). All other variables are as defined in Equation (2). While it is unclear whether informational versus opportunistic motivations can be disentangled for the “big bath” observations (i.e., β_4 and β_5), the inference should be unambiguous for the “non-big bath” observations (i.e., β_2 and β_3).

While we expect consistency across our two analyses, Equation (2) may have less measurement error in the sense that it takes the presentation of special items (which is directly observable) as given, and estimates the “persistence” parameter (which is not directly observable). Thus, it estimates the effect of presentation on persistence. In contrast, the Equation (1) design takes persistence as given, and estimates the “presentation” parameter (i.e., estimates the effect of persistence on presentation). Use of both methods should provide additional robustness to our inferences.

7. Sample Selection and Descriptive Data

To allow for a richer analysis, we derive a sample of firms to obtain a full decomposition of reported special items (see Table 1). We first identify all firm-years falling within the S&P 1500 during the period 1993 – 2002. Our restriction to this subset enables us to capture a broad cross-section of firms while focusing our analysis on a relatively large proportion of U.S. market capitalization. Due to the cost of hand-collection of data, we randomly choose 500 firms from among all firms that fall within the S&P 1500 during our sample period. We include all available firm-years for these firms within the sample period, resulting in a sample of 4,695 firms-years.¹¹

We then hand-collect and categorize all special items using the firm’s 10-Ks, annual reports, and/or 10-Qs. Our collection includes performing key word searches within electronic source documents, as well as scanning management discussion and analysis, the financial statements, and footnotes for indications of special items, regardless of whether Compustat reports that the firm has a special item. We also collect the presentation of special items (income statement or footnote presentation) in the aggregate, by the sign of the special item, and within each of three categories (restructuring, write-offs, and other).^{12, 13}

Table 2 provides descriptive data for our sample. The average firm-year has total assets of \$8.4 billion, consistent with our selection criteria focusing on S&P 1500 firms. Over half of the observations report special items (2,412 out of 4,695, or 51%). Of those reporting special items, slightly more than half report large special items (1,279 out of 2,412, or 53%), and only negative special items (1,452 out of 2,412, or 60%). Special items are distributed widely across the three primary categories of restructuring charges (46% of observations reporting special items), write-offs (34%), and other (71%).¹⁴ Finally, there is substantial variation in firms’ presentation of special items, with 55% (1,335 out of 2,412) presenting all special items as separate line items on the income statement, 30% aggregating all special items in other line items on the income statement with identification only via footnote disclosure, and 15% adopting mixed presentation. Note that our analyses focus on this variation in the presentation decision, as reflected in the bottom three rows and last two columns of Table 2.

8. Empirical Results

Descriptive Statistics and Univariate Results

Table 3 presents descriptive statistics for the sample used to examine the determinants of income statement versus footnote presentation of special items. This sample focuses on those observations reporting special items and having available data for Equation (1) ($N = 2,228$). Panel A presents means and medians for the regression variables. Special items are typically reported as a separate line item on the income statement (mean of $SI_Sep = 0.646$), and on average represent approximately 5% of beginning total assets (mean of $SI_MAG = 0.048$). Special items have an average persistence ($SI_PERSIST$) of 0.21, and 86% of observations reporting special items report a negative special item ($NSI = 0.859$). Almost 21% of observations report negative special items that result in the firm missing prior year's earnings ($MISS_PYE = 0.208$), while only 4% report positive special items that result in the firm beating prior year's earnings ($BEAT_PYE = 0.039$). This latter is consistent with the generally conservative nature of how special items are reported – leading to a higher frequency (and concurrent greater impact on benchmarks) of negative than

positive special items (see, for example, Basu 1997). Panel B presents Pearson correlations, with univariate associations generally consistent with our previously discussed predictions.

Table 4 presents univariate comparisons of observations reporting special items under

income statement versus footnote presentation; for expositional convenience, we present results

only for the magnitude of special items (SI_MAG) and our key construct for economic

performance, the persistence of special items ($SI_PERSIST$). The table provides several insights.

Panel A, examining all observations with necessary data ($N = 2,228$), reveals that special items

receiving income statement presentation are larger in magnitude (e.g., SI_MAG mean of 0.062

versus 0.015) and less persistent ($SI_PERSIST$ of 0.181 versus 0.304). Panels B and C decompose

the sample into observations likely to reflect “big bath” reporting incentives ($N = 406$) and those

unlikely to reflect these incentives ($N = 1,822$). In Panel B, within the subset of “big bath”

observations, larger special items are more likely to receive income statement presentation

(SI_MAG mean of 0.101 versus 0.054), but differences in persistence are insignificant

($SI_PERSIST$ mean of 0.135 versus 0.251). In Panel C, within the subset of “non-big bath”

observations, special items presented on the income statement are again larger (SI_MAG of 0.051

versus 0.011), as well as less persistent ($SI_PERSIST$ of 0.199 versus 0.309). For the latter

observations, this provides preliminary evidence that this presentation decision reflects

informational motivations, as incentives to distort (i.e., “big bath” reporting incentives) are

unlikely to reside in this subsample. We now turn to the multivariate analysis for further evidence.

9. Determinants of Financial Statement Presentation of Special Items

Table 5 presents results from OLS analyses examining the determinants of management's decision to present special items as a separate line item on the income statement. Focusing on all observations (column 1, $N = 2,228$), of our control variables, *SIZE* is negatively associated with this decision, consistent with larger firms being less likely to separately present special items. In addition, the coefficient on *INST* is significantly positive, consistent with managers being more likely to separately present special items as institutional ownership increases.¹⁵ Finally, *SI_MAG* is positively associated with this decision, consistent with materiality affecting the presentation decision, as larger special items are more likely to receive income statement presentation. The coefficient on *YEAR* is negative and insignificant.¹⁶

Regarding our experimental variables, *SI_PERSIST* is negative and significant as predicted (coefficient = -0.03 , t -statistic = -2.89), indicating managers are more likely to provide income statement presentation for those special items having lower persistence. This is consistent with managers being able to identify more transitory special items *ex ante*, and using income statement presentation to identify transitory versus recurring reporting items (i.e., for informational motivations). In addition, *NSI* is positive and significant (coefficient = 0.12 , t -statistic = 4.32), indicating that *ceteris paribus* managers are more likely to present negative special items separately on the income statement than positive special items. Of the reporting incentive variables, only *MISS_PYE* is significantly positive as predicted (coefficient = 0.14 , t -statistic = 5.78), indicating that managers are more likely to provide income statement presentation for special items that cause current year's earnings to fall below previous year's earnings. This is consistent with managers using income statement presentation to highlight negative special items that affect a relevant earnings benchmark (i.e., for opportunistic motivations).

10. Sensitivity Analyses

In this section, we conduct several sensitivity analyses to validate our results. First, we partition on the magnitude of special items. Second, we examine partitions on the sign and category of special items. Third, we examine an alternative disclosure context: press releases. Finally, we conduct analyses on several subsamples.

Partitioning on the Magnitude of Special Items

Table 8 presents results for analyses partitioning the sample into large and small special items. This analysis is warranted, if our previous decomposition of the sample into "big bath" and "non-big bath" observations does not fully capture observations affected by "big bath" reporting incentives. Thus, the "large" designation will capture any observation reporting substantial special items (i.e., having "big bath" incentives). In contrast, small special items should be unaffected by these incentives. Consistent with prior research (e.g., Elliott and Hanna 1996), we define large (small) special items as those in aggregate that are greater than or equal to (less than) 1% of lagged total assets.

Partitioning on the Sign and Category of Special Item

We now examine the consistency of our results across two additional partitions of the data: the sign and category of reported special items. Regarding the sign of special items, we examine if differential persistence exists across the presentation of special items, conditional on their signed effect on reported income (i.e., positive special items, or *PSI*, and negative special items, or *NSI*) (Burgstahler, Jiambalvo, and Shevlin 2002). Untabulated results reveal consistent directional evidence that special items presented in the income statement are less persistent than those presented in the footnotes for both positive and negative special items; however, significance levels vary depending on the sub-sample employed.

7. Conclusion

This paper examines whether managers' presentation decisions within the financial statements reflect informational motivations (that is, revealing the underlying economics of the firm) or opportunistic motivations (that is, attempts to bias perceptions of firm performance). Specifically, we examine managers' decision to present special items separately on the income statement (income statement presentation), versus aggregated in other line items with disclosure in the footnotes only (footnote presentation). This analysis is motivated by prior research, which provides evidence that managers engage in opportunistic reporting in other presentation decisions (e.g., Schrand and Walther 2000; Bhattacharya et al. 2003), as well as evidence that managers' financial statement presentation decisions can affect users' judgments (Hirst and Hopkins 1998; Maines and McDaniel 2000; Libby, Nelson, and Hunton 2005). It is also motivated by standard-setters' interest in performance reporting and financial statement presentation (FASB 2006; IASB 2006), as well as their movement towards reporting standards likely to increase the occurrence of "non-recurring" type charges that are similar to special items, such as fair value changes.

Overall, our results consistently reveal that special items receiving income statement presentation are more transitory than those receiving footnote presentation. For observations reporting special items that are unlikely affected by "big bath" reporting incentives (representing over three-quarters of our special items observations), these results are consistent with managers using discretion in the financial statement presentation of special items for informational reasons. For observations reporting special items likely to reflect "big bath" reporting incentives (less than one-quarter of our special items observations), we provide limited evidence that opportunistic motivations underlie this presentation decision. Overall, our results extend the findings of prior research examining pro forma reporting by documenting that managers, in most instances, appear to use the flexibility afforded in the presentation of special items to inform users of the underlying economics of these items.

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