Earnings Management using Discontinued Operations

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Abstract

This paper examines if firms use discontinued operations to manage earnings by classification shifting. Our results show that firms with discontinued operations have significantly larger unexpected core earnings than firms with income decreasing special items alone. Consistent with McVay (2006), we find unexpected core earnings reverse the year after a firm reports discontinued operations, indicating that the use of discontinued operations to increase core earnings is a one-time event. We also provide evidence indicating that discontinued operations are used to meet or beat prior year core earnings and avoid negative core earnings. Finally, we find the introduction of SFAS 144 has significantly increased the recognition of discontinued operations but reduced the magnitude of earnings management. The findings of this study may have significant implication for the convergence project on discontinued operations between FASB and IASB.