# CORPORATE GOVERNANCE AND MISCLASSIFICATION OF SPECIAL ITEMS: AN INTERNATIONAL COMPARISON

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**Abstract:**

*This study examined the relation between the misclassification of special items and corporate governance of 75 quoted non-financial firms selected from three Sub-Sahara African countries (Nigeria, Kenya and South Africa) for a period of ten years spanning 2008-2017. Ex-post facto and cross-sectional research design were employed and secondary sources of data were collected from annual reports of the selected firms and were analyzed using descriptive statistics, Pearson Correlation matrix and ordinary least square regression. With an expected core earnings model developed by McVay (2006), to detect classification shifting, we discovered that over 95% of the firms engage in earnings management using classification shifting. Using a sample of 750 firm year observations, we found no significant evidence for misclassification mitigation through establishment of board compensation committee in all our sample of Sub-Sahara African listed firms while board ownership was discovered to have a positive and significant effect in mitigating classification shifting across the 3 countries at 5% level of significance. Board resources was discovered to have negative and significant effect in Kenya and South African firms at 10% level of significance while Nigerian firms revealed insignificant result. This finding is in accordance with positive accounting theory that causes the motivation to choose the method of accounting to benefits management of firms. Again the adjusted R-squared stood at 67.8% approximately. This indicates that all the independent variables jointly explain about 67.8% of the system variation in unexpected core earnings/classification shifting of our sampled non-financial firms over the 10years period while about 32.2% of the total variations were unaccounted for, hence captured by the stochastic error term. We therefore recommend that percentage stock shareholding by both executive and non-executive directors should be minimized in order to reduce misclassification practices while larger board size should be encouraged.*

*Keywords: Earnings management, classification shifting, special items, corporate governance*

## 1.0    INTRODUCTION

The bankruptcy of American reputable energy company like Enron, caused investors and stakeholders to pay more attention to the quality of financial statements. Unclear financial statement preparation process leaves a gap of creative accounting which results in the financial statements that reflect such unreal financial status and results of operations (Wasukarn, 2015).

The actual purpose of the financial statements is to present financial status, performance, and changes in financial position for the user of business decisions. Therefore, investors need to consider the accuracy of the financial statements in order to distinguish between actual performance statement and decorative statement to obtain performance required by management. Lately, many countries pay more attention to the quality of financial statements especially in profit numbers. Financial statement distortion of executive caused higher stock prices which

were a signal to investors to make discrepancy investment decisions. Thereafter, investors show more consideration on both quantitative and qualitative information before investing. Therefore, appropriate disclosure is so important to the financial statement determination of all users (Wasukarm; 2015).

Even, regulatory agencies in both public and private sector have set up various measures in order to establish creditability to financial statement users. Particularly, Corporate governance code requires that the financial statements of listed companies must be audited or reviewed and certified. It was established to ensure that the information in financial statements has been audited, accurate and reliable. In the words of Riwayati, Markonah and Siladjaja (2016), they argued that the issue of corporate governance is motivated by agency theory which states that the agency problems arise when managing a company apart from its holdings. The owner as a supplier of capital delegates authority to manage the company to professional managers. As a result, the authority to use company resources is in the hands of the executive. It raises possibility of moral hazard where management does not act in the best interests of the owners (conflict of interest). Also, we verify that the board can oversee management to disclose information in a transparent, fairness and accountability to minority shareholders. To achieve good corporate governance, it requires a systematic mechanism to monitor all policies (Riwayati, Markonah & Siladjaja :2016). According to this viewpoint, using corporate governance to improve the internal and external control of managers (for example, by monitoring the board of directors) may decrease opportunities for earnings management and improve the credibility of financial information (Dey 2005; Rogers 2006). From a rational standpoint, earnings management is a consequence of the agency problem and it can be mitigated by a good corporate board structure. In other words, good corporate governance can be considered a means of controlling managers in the realm of monitoring and corporate reporting.

Classification shifting of income statement items is used as an earnings management tool to shift items with a recurring nature to items with a non-recurring nature in order to increase core earnings while net earnings remain equal. Nonrecurring items can be decomposed into discontinued operations, extraordinary items and special items. The latter is the component of attention in the current study because there is more personal judgment required in reporting special items relative to other nonrecurring items. This makes these items good objects for manipulation and an interesting field of research. Special items are not strictly defined in the accounting standards: they are unusual in nature or infrequent in occurrence but not both. They can be recorded as separate line item or within another account and disclosed in a footnote. Special items can be positive and negative. Positive special items are mostly gains on asset disposals while the most prominent negative special items are asset write-offs and restructuring charges. Even though the magnitude of net earnings is unaffected, misclassification of expenses is misleading to financial statement users because different income statement components have different information content that are informative to assess profitability or to predict future earnings. Misclassified income statement components indicate that the financial statements do not provide a true and fair view of the financial statement, which is a violation of an objective of the conceptual framework. It is expected that classification shifting is used in Sub-Sahara African firms to overstate core earnings because non-recurring items are lightly regulated under International Financial Reporting Standard.

Most prior studies on the classification shifting approach to earnings management has been found in a setting highly regulated through accounting standards and in developed countries like Texas, United Kingdom and scholars did not do many researches in this field and the understanding is still limited. The relatively few studies on classification shifting primarily focused on motivations and provided compelling evidence that management are motivated to misclassify recurring expenses as non-recurring or special items when such practices allows them to meet or beat predetermined earnings benchmarks (Athanasakou et al., 2009; Barua, Lin and Sbaraglia, 2010; Fan, Barua, Cready & Thomas, 2010; McVay, 2006; Bedard, Chtourou and Courteau, 2004; Hossain, Mitra, Rezaee and Sarath, 2011; Klein, 2002; Peasnell Pope and Young, 2005; Xie, Davidson and Dadalt 2003). Thus, there is little evidence available on whether corporate governance collaborates or substitutes for strict accounting regulations. However, these studies presumed that the ability for classificatory manipulation is homogeneous across Sub-Sahara African firms, and such practices are always less likely to attract monitors' and regulators' scrutiny. From the bulk of foreign researches, managers achieve earnings targets using all the three forms of earnings management and a small number

of researches were concerned about the classification shifting, thus giving room for further studies. However, investigating the role of corporate governance in mitigating classification shifting practices helps to fill another gap in the literature. Therefore, this study aims to investigate the effect of corporate governance on earnings management using classification shifting of special items approach among quoted non-financial firms in Sub-Sahara African countries.

Against this backdrop, the following objectives were raised to guide this study.

I. Assess how Board Ownership affects classification shifting of earnings management of quoted non-financial firms in Sub-Sahara African (SSA) countries.
II. Evaluate the extent to which Board Resources affects misclassification of special items (earnings management) of listed non-financial firms in Sub-Saharan African (SSA) countries.
III. Determine the effect of Board Compensation Committee on classification shifting of earnings management of quoted non-financial firms in Sub-Saharan African (SSA) countries.

## 2.0　　　　　　　THEORETICAL CONSTRUCTS

### 2.1.1　Misclassification of Special Items/Classification Shifting

Unlike recurring expenses, special items are by definition infrequent or transitory in nature. Special items are not strictly defined in the accounting standards: they are unusual in nature or infrequent in occurrence but not both. They do not occur frequently in the financial statement and as such users of financial statement especially less sophisticated investors, appear not to understand their nature and as a result of that, they weight individual categories within the income statement differently. This might motivate some managers to misclassify a portion of their recurring expenses as non-recurring thereby inflating their core earnings. Non-recurring items can be decomposed into discontinued operations, extraordinary items and special items. Special items are used by managers to influence the trend in reported earnings and to influence investor and analyst perceptions about the transitory nature of special items. The special item is the component of attention in the current study because there is more personal judgment required in reporting special items relative to other non-recurring items. This makes these items good objects for manipulation and an interesting field of research. Two types of special items are used by management for classification shifting. The two types of special items are positive special items and negative special items, where special items are positive, it corresponds to income-decreasing but where special items are negative it corresponds to income-increasing (Fan et al., 2010; McVay, 2006). They can be recorded as separate line item or within another account and disclosed in a footnote. Positive special items are special items that are mostly gains on asset disposals or item of income while negative special items are special item of expenses or losses.

The most prominent negative special items are asset write-offs and restructuring charges. We focused on classification shifting of both income-decreasing special items and income-increasing special items. Income-decreasing special items are more likely to be presented as line items in income statements to emphasize their transitory nature and that income-increasing special items are more likely to be found in footnotes to the financial statements to mask their transitory nature. Managers can use special items to manipulate earnings. These items are especially suited for earnings manipulation because there is subjectivity involved in classifying such expenses.

In the words of Zalata and Roberts (2016), they opined that Classification shifting is not related to the recognition or the measurement of items; rather, it is related to the misclassification of recurring expenses as non-recurring within the income statement. In particular, classification shifting can be achieved by shifting expenses down from recurring items to non-recurring and special items, and therefore inflate their core earnings number instead of bottom line net income. The main aim of classification shifting is generally to inflate firms' core earnings through the misclassification of some recurring expenses or operating expenses as non-recurring within the income statement.

### 2.1.2    Board Ownership:

Board ownership structure is a measure of the existence of large shareholders in a firm. It is argued that an effective mechanism to constrain earnings management is the development of an appropriate ownership structure. Fan and Wong (2002) measured different types of ownership structures, including concentrated-level, associated-pyramidal, and cross-holding structures. Major shareholders have a conflict of interest with minority shareholders, as they are more likely to prevent disclosure of proprietary information to the minority or the public, and are also likely to manipulate the reporting of earnings to cover self-interest behavior. The problems of lower earnings quality, more earnings management and less in formativeness are not because of poor accounting standards; in fact, many East Asian countries have already imposed international accounting standards or have complied with international accounting standards to make some changes. Rather, these problems are largely due to poor corporate structure, one of the elements of corporate governance. Agency theory states that less concentrated ownership may have incentives for the managers to manipulate the financial numbers for their personal benefit in order to get more earning-based bonuses and less pressure from other shareholders. Past studies have shown that concentrated or block ownership can increase the monitoring effectiveness of the board (Gulzar & Wang; 2011). Board ownership can restrict the opportunistic behavior of management. On the other hand, the board ownership may be ineffective in prompting insiders to make valuable decisions in their own interest, which may result in increased classification shifting practices (Cornett, Marcus, & Tehranian, 2008). Therefore, the presence of shareholders owning a large block of shares in a company provides an additional monitoring mechanism that may deter opportunistic earnings management.

### 2.1.3:    Board Resources:

There was a very large literature on the optimal composition of boards. The number of board members is used as an indication of resources available to the board. Board must have adequate resources to do its job perfectly well. This generally agrees that the size of the board is important, although the optimal size appears to depend on many factors which include the size of the firm, the complexity of the firm, the industry it operates in and the proportion of insiders and outsiders on the board (Zalata and Roberts; 2016). When the size of the board increases, board effectiveness is improved because it has sufficient resources to address the issues faced by the company. Because of the comprehensive responsibilities, scope and complex nature of the accounting and financial matters reviewed, the board needs significant resources to carry out their job effectively (Sri and Sylvia, 2016). DeZoort et al. (2002) asserted that adequate number of board members is needed to generate substantive discussion and to consider emerging issues as well as access to management and to both external and internal auditors. Mohammad-Nor et al (2010) argued that most of the problems in the financial statement are more likely to be uncovered and resolved with a larger board committee. Sri and Sylvia (2016) suggested having a board number that is not too large as to become unwieldy but number that is sufficiently large to ensure appropriate monitoring. It is easier to coordinate small boards and they are more likely to mean that directors know each other well, have effective discussions and reach true consensus from their deliberations. However, large boards will often have more independent directors who, with diversified experience are abler to demand private information disclosure by insider members and to curb managers' abnormal accounting practices (Zalata & Roberts; 2016 and Xie et al., 2003).

### 2.1.4:    Board  Compensation Committee

In 2011, Nigerian code of corporate governance required listed companies to form a compensation committee to perform the task of setting executive compensation and all members of the committee were required to be independent directors. In that same year, they even proposed to prohibit firms to list when not complying with SEC rule regarding independence of compensation committee. The main role of the compensation committee is to design

executive incentives and compensation to attract, maintain and motivate top executives and top managers. The main function of the compensation committee is to design incentive plans for top managers. The committee can sometimes exercise its power for special situations in order to achieve this goal. Hence, Nigeria code of corporate governance require listed firms to include a certain proportion of independent directors on a compensation committee to control managers' self-interest, such as overpaying themselves and reducing research and development expenditures. The Nigerian SEC requires that the compensation contracts of top executives of listed companies be approved or recommended by the board by a majority of independent directors. The compensation committees of large firms usually hire external consultants to provide industry-wide compensation data or benchmarking so it can set competitive compensation for top executives. One of the incentives to manage earnings is compensation motivation. Managers are more likely to boost earnings, to earn higher bonuses, by reducing discretionary expenditure such as research and development or by adjusting discretionary accruals. Compensation is used as a control mechanism by board of directors to align the interests of manager's incentives with the shareholders' wealth creation. Compensation in the firm usually refers to the general form of base salary and incentives of board of directors or top executives.

## 2.2:        THEORETICAL FRAMEWORK

This article was anchored on Positive Accounting Theory (PAT). Watts and Zimmerman (1986) developed the positive accounting theory that aims to explain and predict accounting practice. It is concerned with actions such as which accounting policies management chooses and how management responds to proposed new accounting standards. It explains earnings management in the preparation of reported financial statements. That is why this article is anchored on positive accounting theory. Positive Accounting Theory assumes that all individuals are rational and act in self-interest to maximize their own utility, which corresponds with the Agency Theory perspective. When management has the flexibility to determine the accounting policy, the possibility of opportunistic behavior arises (ex post) (Scott, 2012). Managers will choose the accounting method that maximizes their own utility and thereby reducing contract efficiency (ex post). In the efficient contracting view, managers choose accounting policies to maximize contract efficiency; managers choose accounting methods that present the true performance of the firm and result in firm value maximization. Recognizing that managers must have flexibility in their reporting choices to reflect the true economic circumstances of the firm, the problem of opportunistic behaviour arises. In the opportunistic view, managers choose accounting policies to maximize their own personal interests, and not in the best interests of the shareholders. They choose accounting methods that is in their benefit, even if it's at the expense of the contractors. As managers' possess more inside information than providers of finance, these providers of finance face agency costs to monitor managers' behavior. In addition, contracts between managers and providers of finance sometimes required the managers to disclose accounting information to the providers of finance in order to monitor their financial providers' interests and wealth. However, this information is provided by the managers (Watts and Zimmerman, 1986), who may choose to overstate the numbers in the financial statements through their accounting estimates and standards. The positive accounting theory does not provide any prescription or state what should happen, and only explains and predicts what would happen.

## 2.3:        EMPIRICAL LITERATURE AND HYPOTHESES DEVELOPMENT

### 2.3.1:   Board ownership and earnings management (classification shifting approach)

Board ownership and earnings management are correlated with earnings in formativeness and earnings quality. Prior studies have documented that board ownership structure can influence firm earnings quality (Anderson & Reeb, 2004; Ali, Chen & Radhakrishnan, 2007). Firms with higher dispersed ownership can reduce earnings management because no majority can control the operation of firms, insiders cannot enjoy private benefits from controlling firms and their interests can align with other owners. Koh (2003) examined firms in Australian with respect to their reaction between managerial ownership and earnings management practice. He discovered a positive relationship between managerial ownership and earnings management. This result is consistent with the view that high managerial ownership encourages managerial accruals discretion. Kazemian and Sanusi (2015) examined the

managerial ownership effect on earnings management and found that earnings management is significantly positive within intermediate regions of ownership, which suggested that the entrenchment effect is dominant in these regions. Leuz et al. (2003), Nenova, (2003); Dyck and Zingales, (2004) indicate that earnings management appears to be lower in firms with dispersed ownership, which can reduce insiders' incentive to conceal classification shifting practices. Sánchez-Ballesta and García-Meca (2007) provide evidence that a lower level of insider ownership is associated with less earnings management which is consistent with previous studies. Koh, 2003, Bowen et al, 2004, Davidson et al. (2005) and Sánchez-Ballesta and García-Meca (2007) found no significant association between board ownership and earnings management. De Bos and Donker (2004) observe that increase in ownership is literally useful in depriving of managerial misconduct and thereby boosting earnings quality. However, there are some inconsistencies that existed in the literature, for that reason, the current study does not intend to propose any sign, rather we hypothesize that *there is a significant relation between board ownership and classification shifting (Hypothesis 1).*

### 2.3.2:   Board Resources and Earnings management (Classification Shifting)

According to previous studies, there are several view points on the association between board resources and earnings management. The empirical findings support both viewpoints that is both large board and small board point of view. Zalata and Roberts (2016) found board size to be negatively and insignificantly associated with classification shifting in all his samples. This provides no support for the importance of board size possibly because of the number of different factors that together seem to determine the optimal board size. Abbott, Parker and Peters (2004) found a significant and positive relationship between board size and the probability of financial statement fraud and earnings restatement respectively. Xie et al. (2003) and Peasnell et al. (2005) found a negative relationship between board size and abnormal working capital accruals whereas Osma (2008) found no significant relationship between board size and real earnings management. Larger boards have more directors with financial expertise increasing monitoring quality (Rashidah et al., 2006) and can more easily participate in quality discussions (DeZoort and Salterio, 2001). The downside however is an increased level of bureaucracy leading to slower decisions (Xie et al., 2003) which makes them less functional to operate (Rashidah et al. 2006). In a similar way, Roodposhti and Chashmi (2003) perceived smaller boards as more efficient in detecting earnings management. Nevertheless, considering the contradicting theoretical argument, this paper does not predict any sign for the board resources (size of the board) but propose that *there is a significant relation between board resources and classification shifting (Hypothesis 2).*

### 2.3.3: Board Compensation Committee and Earnings management (Classification Shifting)

Adut, Cready and Lopez (2003) showed that compensation is only shielded from restructuring charges if it is an initial restructuring. Subsequent restructurings though lower bonus payments to a minor extent than ordinary costs. Otherwise, restructuring charges can be used to manipulate earnings because reversals are not excluded from the computations. While restructuring charges are (partially) excluded from compensation, managers may have the incentive to record as many costs as possible as restructuring charge, even ordinary operating costs. The use of earnings in compensation contracts also provides an incentive to executives to manipulate earnings so their reward increases. Lancee (2010) examined the relation between the misclassification of special items and executive compensation. He also examined whether managers misclassify more core expenses when their compensation depends on core earnings. With an expected core earnings model, developed by McVay (2006), to detect misclassification, He found no significant evidence for misclassification in the sample of US-listed firms. He also reported that although managers may have an incentive (i.e. higher compensation) to misclassify expenses, they do not shift core expenses to special items. Man and Wong (2013) found that the compensation committee values abnormal discretionary expenditures in non-terminal periods but does not value upward real and accrual earnings management in the terminal period. Hence, these findings provide evidence to support the hypothesis that a well-functioning committee governance mechanism (such as a compensation committee) can identify opportunistic earnings management and pricing in the executive compensation setting. However, there is little or no research on whether executives use classification shifting to maximize their pay or not. However, given the conflicting

theoretical arguments, this current study does not intend to predict any sign for board compensation committee: All things being equal, ***there is a significant relationship between board compensation committee and classification shifting (Hypothesis 3).***

**3.0          METHODOLOGY**

We adopted ex-post facto research design and cross sectional data as 75 quoted companies selected in equal proportion of 25 firms from each country that cut across all the non-financial firms in Sub-Sahara Africa (Kenya, Nigeria and South Africa) was covered and used to describe whether corporate governance collaborates or substitute classification shifting. Secondary data as the main source of information was utilized and it covered selected quoted non-financial firms within the period of ten years spanning 2008 to 2017. The information relating to the features of corporate governance (board ownership, board resources and board compensation committee) were used as independent variables and earnings management measured with classification shifting was used as our dependent variable while return on assets and firm size were used as control variables. All the variables were analyzed using ordinary least square regression.

To examine whether crucial corporate governance attributes mitigates classification shifting, we concentrated on the misclassification of special items or non-recurring items and investigated the association between unexpected core earnings and non-recurring expenses, and anticipate that firms' core earnings will be overstated in the period when non-recurring items are recognized. Following McVay (2006) model, we determined a proxy for normal core earnings for each of the 75 firms in the sample using the following expectation model as our step 1:

$$EXP\text{-}CE_{i,t} = \beta_0 + \beta_1 CE_{t-1} + \beta_2 ATO_{i\,t} + \beta_3 ACCRUALS_{t-1} + \beta_4 ACCRUALS_t + \beta_5 \Lambda SALES_{i,t} + \beta_6 NEG. \Lambda SALES + \varepsilon_{It}$$
$$\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots(1)$$

We then estimate the following model as our step 2 equation to investigate whether Sub-Sahara Africa firms misclassify recurring expenses into non-recurring items or special items. Thus, the equation was captured as follows:

$$UNEXP\text{-}CE = \beta_0 + \beta_1 NREC_{1t} + Control \quad variables_{1t} + \varepsilon_{It}\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots(2)$$

Where

UNEXP-CE means Unexpected Core Earnings computed as difference between reported core earnings and expected core earnings where the expected core earning value is calculated using the coefficients from Step (1) equation above while NREC stands for non-recurring items measured as the difference between reported core earnings and bottom line net income scaled by sales. When firms engage in classification shifting, the unexpected core earnings increases with non-recurring items and thus we expect coefficient of NREC $(\beta_1)$ to be positive. A positive relationship between unexpected core earnings and non-recurring item is an evidence of classification shifting (CS). This also suggests that firms shift recurring/core expenses to non-recurring items/special items to inflate core earnings, thus evidence of classification shifting (CS).

**Table 3.1:      Regression of Unexpected Core Earnings on Non-Recurring Items** *(Test of classification shifting among 75 non-financial firms in 3 Sub-Sahara African countries)*

$$UNEXP\text{-}CE = \beta_0 + \beta_1 NREC_{1t} + Control \quad variables_{1t} + \varepsilon_{It}\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots(2)$$

**Dependent Variable: UNEXPCE**
**Method: Panel Least Squares**
**Date: 25/11/18   Time: 11:15**
**Sample: 2008 2017**
**Periods included: 10**
**Cross-sections included: 75**
**Total panel (balanced) observations: 750**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | 0.845941 | 0.250283 | 3.379943 | 0.0008 |
| NREC | 30.78411 | 1.296397 | 23.74590 | 0.0000 |
| FSIZE | -0.181316 | 0.004314 | -42.02699 | 0.0000 |
| ROA | 5.708417 | 0.203722 | 28.02060 | 0.0000 |
| R-squared | 0.773618 | Mean dependent var | | -6.935587 |
| Adjusted R-squared | 0.772708 | S.D. dependent var | | 5.781251 |
| S.E. of regression | 2.756220 | Akaike info criterion | | 4.870917 |
| Sum squared resid | 5667.175 | Schwarz criterion | | 4.895557 |
| Log likelihood | -1822.594 | Hannan-Quinn criter. | | 4.880411 |
| F-statistic | 849.7735 | Durbin-Watson stat | | 1.133637 |
| Prob(F-statistic) | 0.000000 | | | |

**Source: Researchers' summary of regression result from Eview 8.0**

Before investigating whether corporate governance mitigates classification shifting, we first of all investigated whether Sub-Sahara African non-financial firms currently see classification shifting as a viable manipulation method. Table 3.1 above shows basic regression testing conducted to investigate whether there is a positive relationship between non-recurring items (NREC) and unexpected core earnings (UNEXPCE), hence a positive coefficient value is assumed. As expected, it shows that, there is a significant positive relationship between NREC and UNEXPCE among our sampled firms. This suggests that some Sub-Sahara African firms might have shifted some recurring (core) expenses to non-recurring expenses to inflate their core earnings (core profit) which were an evidence of classification shifting. That is to show that classification shifting has become more pervasive in non-financial firms across Sub-Sahara African countries.

The result above shows that non-recurring expenses have positive effect on unexpected core earnings. The probability value shows that the effect of non-recurring expenses on unexpected core earnings is statistically significant at 1% level.  This means that as non-recurring expenses is increasing, unexpected core earnings is also increasing, thus evidence of misclassification among firms quoted in Sub-Sahara Africa. The $R^2$ indicates that non-recurring expenses/special items and other control variables can explain about 77% of changes in the unexpected core earnings. Thus, about 77% of changes in unexpected core earnings can be attributable to non-recurring expenses while about 23% were captured by the error terms.

Now that we have confirmed the existence and evidence of classification shift among selected non-financial firms in Sub-Sahara Africa, we can now proceed with the main regression analysis to see if corporate governance collaborates or mitigate misclassification shifting, hence the analysis of unexpected core earnings with corporate governance variables.

To test hypothesis 1 to 3, we included non-recurring items to further establish the evidence of classification shifting while return on asset (ROA) and firm size (FSIZE) were added as control variables to control for performance. The regression model then takes the following form:

$$UNEXP\text{-}CE = \beta_0 + \beta_1 NREC_{1t} + \beta_2 BOWN_{1t} + \beta_3 BRES_{1t} + \beta_4 BCOMC_{1t} + \beta_5 ROA_{1t} + \beta_6 ACD_{1t} + \mathcal{E}_{1t}..............................................................................................................(3)$$

Where

**UNEXP_CE** =Unexpected core earnings measured as difference between reported core earnings and expected core earnings. **NREC** stands for non-recurring items measured as the difference between reported core earnings and bottom line net income scaled by sales. **BOWN** means board ownership measure as the proportion of shares held by non-executive board members to the total number of outstanding shares at year-end. **BRES** stands for board resources captured as the total number of board members; **BCOMC** represents board compensation committee measured with a indicator variable *with the value of "1" if there is board compensation committee and "0" otherwise*; **ROA** is the return on assets measured as net income divided by the average total assets and **FSIZE** means firm size measured as the natural log of total assets.

## 4.0 ESTIMATION RESULTS AND DISCUSSION OF FINDINGS

Table 4.1 below reports the descriptive statistics pertaining to the entirety of variables investigated in this study.

### 4.1 Descriptive Statistics Analysis

|  | UNEXPCE | NREC | BOWN | BRES | BCOMC | ROA | FSIZE |
|---|---|---|---|---|---|---|---|
| Mean | 1.4023 | 0.9477 | 15.339 | 7.9572 | 0.8238 | 0.5617 | 47.674 |
| Median | 0.8900 | 0.0800 | 3.7200 | 8.0000 | 1.0000 | 0.6100 | 46.650 |
| Maximum | 340.55 | 226.97 | 71.931 | 13.000 | 1.0000 | 1.5800 | 317.19 |
| Minimum | -288.02 | -80.000 | 11.180 | 4.0000 | 0.0000 | -0.8300 | 10.540 |
| Std. Dev. | 23.311 | 10.366 | 29.240 | 1.2980 | 0.3982 | 0.3238 | 23.428 |
| Skewness | -0.1019 | 14.475 | 2.3185 | 0.1846 | -1.5214 | -0.7384 | 4.2423 |
| Kurtosis | 113.91 | 319.96 | 10.202 | 4.2780 | 3.3147 | 4.3311 | 48.648 |
|  |  |  |  |  |  |  |  |
| Jarque-Bera | 37672 | 31023 | 2247.4 | 54.201 | 286.58 | 121.07 | 66020. |
| Probability | 0.0000 | 0.0000 | 0.0000 | 0.0000 | 0.0000 | 0.0000 | 0.0000 |
|  |  |  |  |  |  |  |  |
| Sum | 1030.7 | 696.58 | 10337. | 5864.6 | 590.00 | 412.89 | 35040. |
| Sum Sq. Dev. | 39887 | 78872. | 62758 | 1236.7 | 116.39 | 76.976 | 40289 |
|  |  |  |  |  |  |  |  |
| Observations | 750 | 750 | 750 | 750 | 750 | 750 | 750 |

**Source: researcher summary of descriptive statistics result (2018) using E-view 8**

The descriptive statistics result in Table 4.1 above shows the mean values for each of the variables, their maximum values, minimum values, standard deviation and Jarque-Bera values which show the normality of the data. The result provides some insight into the nature of the selected quoted firms from three Sub-Sahara Africa countries that were used in the study. Firstly, it was observed that minimum and maximum values of unexpected core earnings stood at -288 and 340 respectively. The result also showed that unexpected core earnings as a percentage of sales have positive mean value and median value of 1.402 and 0.890 (89%) respectively. There exists wide difference between the maximum value of 340 and minimum value of -288 of unexpected core earnings. The difference shows

that most of the firms within the period under study have positive unexpected core earnings whereas the mean and median of NREC is 0.9477 (94.77%) and 0.080% respectively suggesting that recurring expenses misclassification has become more pervasive and economically significant among Sub-Saharan African countries. Moreover, the difference between the mean value and the maximum value of non-recurring items indicates that majority of the firms over the period have high non-recurring expenses which also suggested that recurring expenses misclassification has become persistent among firms. The large difference between the maximum unexpected core earnings and minimum unexpected core earnings revealed that the unexpected core earnings of the firms differs greatly among the firms selected and over the period under review, this shows that the firms are not homogenous.The result shows that on the average board members owns about 15.34% shareholding in their respective firms, with a maximum ownership of about 72% and minimum of about 11%. The result showed that board resources which are an indication of size show the mean and median values of 7.95 and 8 respectively ranging from seven to nine members demonstrating an optimal size with the maximum value of 13 members and minimum value of 4 members respectively. The large difference between the mean value and the maximum value indicates that only few firms over the years have smaller board members while others maintain adequate number of resources. The result reveals that 82% of all the firms over the years have a compensation committee in the corporate board while some does not have compensation committee. Lastly, the Jarque -Bera (JB) and its probability which test for normality or existence of outlier shows that all the variables were normally distributed at 1% level of significance

## 4.2. Correlation result

In examining the relationship that exists among the variables, the study employed the Pearson correlation analysis, the summary of the results is presented below.

|  | UNEXPCE | NREC | BOWN | BRES | BCOMC | ROA | FSIZE |
|---|---|---|---|---|---|---|---|
| UNEXPCE | 1.000000 |  |  |  |  |  |  |
| NREC | 0.421538 | 1.000000 |  |  |  |  |  |
| BOWN | -0.091499 | -0.034506 | 1.000000 |  |  |  |  |
| BRES | -0.001228 | -0.034965 | -0.000872 | 1.000000 |  |  |  |
| BCOMC | -0.013079 | -0.026955 | -0.023799 | -0.129203 | 1.000000 |  |  |
| ROA | 0.003503 | 0.054098 | -0.062241 | -0.012646 | 0.065231 | 1.000000 |  |
| FSIZE | -0.003589 | -0.099448 | 0.105291 | 0.004845 | 0.024631 | 0.031133 | 1.000000 |

**Source: researcher summary of correlation analysis result (2018) using E-view 8**

The result indicates that unexpected core earnings are negatively correlated to all the corporate governance variables. This simply means that the larger the board resources and ownership the lower the unexpected core earnings. We also observed a positive association between unexpected core earnings and non-recurring items which also confirms the existence of classification shifting among non-financial firms across Sub-Sahara African countries. Hence the level of unexpected core earnings can be positively influenced by those corporate governance variables. Lastly, in checking for multi-colinearity, the study observed that no two variables were perfectly correlated. This reveals the absence of multi-colinearity in our model.

## 4.3: Regression Result

To evaluate the effect of corporate governance on unexpected core earnings (classification shifting) and to test our formulated hypotheses, we used regression analysis. The result obtained is presented in tables 4.3 below:

**Table 4.3: Regression Result**

Dependent Variable: UNEXPCE
Method: Panel Least Squares
Date: 11/22/18   Time: 03:19
Sample: 2008 2017
Periods included: 10
Cross-sections included: 75
Total panel (balanced) observations: 750

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -1.577179 | 5.699631 | -0.276716 | 0.7821 |
| NREC | 0.956356 | 0.075770 | 12.62189 | 0.0000 |
| BOWN | 0.066605 | 0.026868 | 2.478984 | 0.0134 |
| BRES | -0.230227 | 1.605825 | 0.380023 | 0.0740 |
| BCOMC | -0.084559 | 1.979491 | -0.042718 | 0.9659 |
| ROA | 2.697973 | 0.421345 | 5.771489 | 0.0000 |
| FSIZE | 0.048039 | 0.033640 | 1.428028 | 0.1537 |

| | | | | |
|---|---|---|---|---|
| R-squared | 0.686650 | Mean dependent var | | 1.402367 |
| Adjusted R-squared | 0.677947 | S.D. dependent var | | 23.31143 |
| S.E. of regression | 21.11008 | Akaike info criterion | | 8.946857 |
| Sum squared resid | 324422.8 | Schwarz criterion | | 8.990665 |
| Log likelihood | -3280.970 | Hannan-Quinn criter. | | 8.963753 |
| F-statistic | 27.84401 | Durbin-Watson stat | | 1.799377 |
| Prob(F-statistic) | 0.000000 | | | |

**Source: Researcher's summary of regression analysis (2018) from e-view 8**

The table 4.3 above shows the ordinary least square regression analysis of quoted non-financial firms in three Sub-Saharan African countries namely Nigeria, Kenya and South Africa. From the result above, the study observed that the R. squared value is 0.686 (68.7%) and R-squared adjusted value is 0.677 (67.8%) approximately. The value of R- squared which is the coefficient of determination stood at 68.7% which implies that 68.7% of the systematic variations in individual dependent variables were explained in the model while about 31.3% were unexplained thereby captured by the stochastic error term. Again, the adjusted R-squared stood at 67.8% approximately. This indicates that all the independent variables jointly explain about 67.8% of the system variation in unexpected core earnings/classification shifting of our sampled non-financial firms over the 10years period while about 32.2% of the total variations were unaccounted for, hence captured by the stochastic error term. This reveals that about 67.8% misclassification shifting of recurring items into non-recurring items which gave rise to unexpected core earnings/classification shifting can be attributable to the corporate governance variables selected for the study while about 32.2% were unexplained. Moreover, the F-statistics value of 27.84 and its probability value of 0.000 shows that the unexpected core earnings model used for the analysis were statistically significant at 1% level. This confirms the appropriateness of our model used for the analysis. The Durbin Watson statistics value of 1.799 reveals the absence of autocorrelation in our model.

In addition to the above, the specific findings from each explanatory variable were provided as follows:

***Ho1:    Board ownership has no significant effect on classification shifting of earnings management of quoted non-financial firms in Sub-Sahara Africa.***

Based on t-statistics values of board ownership and its coefficient value, the result of unexpected earnings/classification shifting model showed that board ownership has coefficient value of 0.0667 and a P-value of 0.0134. The result from the regression analysis indicates that Board ownership has positive influence on classification shifting of firms in Sub-Sahara Africa. The positive influence on classification shifting suggests that misclassification of special items is more likely to occur when both dependent and independent members own stock of the firm, as increase in their stock holding leads to increase in classification shifting. Our positive result finding supports  Zalata and Roberts (2016),Wasukarn (2015), Isenmila and Elijah (2012), Kazemian and Sanusi (2015), Gulzar and Wang (2011), Kamram and Shah (2014), Yang and Krishnans's (2005) argument that non-executives directors' holding more stock are more likely to collude with management and become reluctant to challenge them while our result contradicts the view that stock ownership minimizes agency problems by helping to align directors' interests with shareholders' interests as documented by the following prior studies Essa, Kahir and Nguyen (2016) that found negative relation between board ownership and earnings management while our finding also negates the finding of Kamram and Shah (2014) and Gulzar and Wang (2011) who found no evidence to support the existence of board ownership as a tool for earnings management. Meanwhile, the probability value from the model revealed that board ownership has statistically significant effect on classification shifting which was statistical significant at 5% level of significance. As a result of this statistically significant effect, we therefore accept our alternate hypothesis and conclude that board ownership has significant effect on classification shifting of earnings management of non-financial firms in Sub-Sahara Africa.

***H₀2:    Board resources have no significant effect on classification shifting of earnings management.***

Based on the regression result in table 4.3. above, we observed that board resources showed a coefficient value of -0.230, and P-value of 0.0740. The result from the analyis indicates that board resources which were an indication of size have negative and significant influence on the level of classification shifting of quoted non-financial firms in Sub-Sahara Africa. This suggests that the negative coefficient indicate that board resources negatively influence the level of classification shifting. This implies that 1% increase in the number of board leads to a percentage decrease in classification shifting by 0.230% thus providing strong support for the importance of large board size, possibly because of the number of different factors that together seem to determine the optimal board size. This suggests that larger board size can lead to a decrease in the level of unexpected core earnings as any error not dictated by one person will be dictated by another. Again, larger boards were associated with improved financial disclosure as they have more oversight and therefore improve earnings quality thereby mitigating misclassification shifting practices. This finding supports the findings of Lin et al (2006), Peasnell et al (2005), Xie et al. (2003) and Bedard et al. (2004) that reported negative and significant relation between board size and earnings management but disagrees with findings of Essa, Kahir and Nguyen (2016) and Rashidah and Ali (2006) that reported positive relation between board size and earnings management and argued that smaller boards are more effective than larger board in monitoring process since larger board faces control problems and conflicts of interest. Also our finding negates the findings of Gulzar and Wang (2011), Baxter and Cotter (2009) and Kamram and Shah (2014) that found no evidence that board size influences earnings management and the findings of Jouber and Fakhfakh who found a neutral relationship between board size and earnings management. The probability value and t-statistic value reveals that board resources has statistical significant effect on unexpected core earnings of firms quoted in stock exchange of countries in Sub-Sahara Africa which was statistically significant at 10% level of significance. As a result of this significant relationship we documented, we rejected our null hypothesis and accept our alternate hypothesis and therefore conclude that board resources have significant effect on classification shifting of earnings management of quoted non-financial firms in Sub-Sahara Africa.

*$H_0$3:   Board compensation committee has no significant effect on classification shifting of earnings management of quoted non-financial firms in Sub-Sahara Africa.*

From the result of regression analysis above, board compensation committee has coefficient value of -0.0845 and P-value of 0.965. The result indicates that compensation committee has negative influence on the level of classification shifting of firms which was not statistically significant. Thus providing support to the expectation that existence of board compensation committee was better at mitigating manipulation at least when the firm has more opportunity to manipulate, i.e. when the firm has non-recurring expenses. This implies that any additional effort makes in trying to maintain such committee on different firms' board improves their earnings management while insufficient monitoring from board combined with executive remuneration allows managers a lot of discretion over accounting numbers. This indicates that having a compensation committee on corporate board demonstrates that classification shifting is less prevalent in firms with existence of functional compensation committee as they are more likely to challenge aggressive misrepresentation of recurring items rather than monitoring less effectively. Our findings agree with the findings of Eckles et al. (2011) but contradicts the findings of Lancee (2010) that found no significant evidence for misclassification in the sample of US-listed firms. The result means that though board compensation committee has negative influence on classification shifting, the influence is not effective in driving the level of classification shifting among firms in Sub-Sahara Africa because the result was found to be statistically insignificant. Based on this, we accepted our null hypothesis and rejected our alternate hypothesis, then conclude that compensation committee has positive but insignificant effect on classification shifting of earnings management of quoted non-financial firms in Sub-Sahara Africa.

## CONCLUSION

We measure opportunistic managerial discretion by the magnitude of classification shifting and use this to assess the effect of strong internal corporate governance.  We investigated whether corporate governance is able to mitigate classification shifting knowing fully well that the value of a strong board is very important because they constitute a form of monitoring, curbing opportunistic managerial behavior and therefore reducing information risk. Drawing on 750 firm year observations over a period of ten years from 2008 to 2017, we investigate whether corporate governance is able to mitigate classification shifting. Consistent with prior studies on misclassification of special items, our results show that strong internal corporate governance appears to challenge management's opportunistic disclosure of special items.

We therefore recommend that percentage stock shareholding by both executive and non-executive directors should be minimized in order to reduce misclassification practices while larger board size should be encouraged. Moreover, emphasis to establish board compensation committee at corporate firm's level should be ignored as it has insignificant effect in the level of classification shifting.

**APPENDIX**

**TABLE 4.1**

**DESCRIPTIVE STATISTICS**

|  | UNEXPCE | NREC | BOWN | BRES | BCOMC | ROA | FSIZE |
|---|---|---|---|---|---|---|---|
| Mean | 1.402367 | 0.947728 | 15.33965 | 7.957270 | 0.823872 | 0.561755 | 47.67400 |
| Median | 0.890000 | 0.080000 | 3.720000 | 8.000000 | 1.000000 | 0.610000 | 46.65000 |
| Maximum | 340.5500 | 226.9700 | 71.93100 | 13.00000 | 1.000000 | 1.580000 | 317.1900 |
| Minimum | -288.0200 | -80.00000 | 11.18000 | 4.000000 | 0.000000 | -0.830000 | 10.54000 |
| Std. Dev. | 23.31143 | 10.36605 | 29.24083 | 1.298046 | 0.398216 | 0.323840 | 23.42871 |
| Skewness | -0.101991 | 14.47588 | 2.318532 | 0.184685 | -1.521423 | -0.738483 | 4.242359 |
| Kurtosis | 113.9108 | 319.9600 | 10.20296 | 4.278049 | 3.314728 | 4.331177 | 48.64841 |
| Jarque-Bera | 376725.6 | 3102369. | 2247.417 | 54.20146 | 286.5877 | 121.0747 | 66020.39 |
| Probability | 0.000000 | 0.000000 | 0.000000 | 0.000000 | 0.000000 | 0.000000 | 0.000000 |
| Sum | 1030.740 | 696.5800 | 10337.82 | 5864.690 | 590.0000 | 412.8900 | 35040.39 |
| Sum Sq. Dev. | 398872.5 | 78872.01 | 627589.2 | 1236.733 | 116.3946 | 76.97624 | 402895.9 |
| Observations | 750 | 750 | 750 | 750 | 750 | 750 | 750 |

**TABLE 4.2**

**CORRELATION RESULT**

|  | UNEXPCE | NREC | BOWN | BRES | BCOMC | ROA | FSIZE |
|---|---|---|---|---|---|---|---|
| UNEXPCE | 1.000000 | 0.421538 | -0.091499 | -0.001228 | -0.013079 | 0.003503 | -0.003589 |
| NREC | 0.421538 | 1.000000 | -0.034506 | -0.034965 | -0.026955 | 0.054098 | -0.099448 |
| BOWN | -0.091499 | -0.034506 | 1.000000 | -0.000872 | -0.023799 | -0.062241 | 0.105291 |
| BRES | -0.001228 | -0.034965 | -0.000872 | 1.000000 | -0.129203 | -0.012646 | 0.004845 |
| BCOMC | -0.013079 | -0.026955 | -0.023799 | -0.129203 | 1.000000 | 0.065231 | 0.024631 |
| ROA | 0.003503 | 0.054098 | -0.062241 | -0.012646 | 0.065231 | 1.000000 | 0.031133 |
| FSIZE | -0.003589 | -0.099448 | 0.105291 | 0.004845 | 0.024631 | 0.031133 | 1.000000 |

**TABLE 4.3**

**REGRESSION RESULT**

Dependent Variable: UNEXPCE
Method: Panel Least Squares
Date: 11/22/18   Time: 03:19
Sample: 2008 2017
Periods included: 10
Cross-sections included: 75
Total panel (balanced) observations: 750

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -1.577179 | 5.699631 | -0.276716 | 0.7821 |
| NREC | 0.956356 | 0.075770 | 12.62189 | 0.0000 |
| BOWN | 0.066605 | 0.026868 | -2.478984 | 0.0134 |
| BRES | -0.230227 | 0.605825 | 0.380023 | 0.0740 |
| BCOMC | -0.084559 | 1.979491 | -0.042718 | 0.9659 |
| ROA | 2.697973 | 0.421345 | 5.771489 | 0.0000 |
| FSIZE | 0.048039 | 0.033640 | 1.428028 | 0.1537 |

| | | | | |
|---|---|---|---|---|
| R-squared | 0.686650 | Mean dependent var | | 1.402367 |
| Adjusted R-squared | 0.679947 | S.D. dependent var | | 23.31143 |
| S.E. of regression | 21.11008 | Akaike info criterion | | 8.946857 |
| Sum squared resid | 324422.8 | Schwarz criterion | | 8.990665 |
| Log likelihood | -3280.970 | Hannan-Quinn criter. | | 8.963753 |
| F-statistic | 27.84401 | Durbin-Watson stat | | 1.799377 |
| Prob(F-statistic) | 0.000000 | | | |