Corporate Governance and Classification Shifting in China's Listed Firms: Beyond Accrual and Real Earnings Management

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ABSTRACT

Classification shifting alters the apparent composition of financial performance without necessarily changing net income, yet governance research often treats it as interchangeable with accrual-based and real earnings management. This focused narrative review evaluates evidence on classification shifting in Chinese listed firms and develops a category-specific explanation of when governance can constrain it. The synthesis distinguishes movements of recurring expenses into special items, nonoperating gains into operating revenue, and reallocations between operating expense categories, particularly research and development (R&D). It integrates direct studies with adjacent evidence on boards, supervisory arrangements, ownership, auditors, analysts and market competition, while evaluating the limits of residual-based measures and observational research. China's 2018 change in R&D presentation provides an important setting, but higher disclosed expenditure cannot by itself establish opportunistic relabeling rather than genuine investment or a defensible cost allocation. The proposed framework links the affected reporting measure and managerial incentive to a monitor's authority, independence, access to verifiable records and interaction with other monitors. The review identifies why governance associations should differ across classification routes and develops testable propositions concerning board–auditor complementarity, ownership incentives, external scrutiny and changes in Chinese oversight institutions. The contribution is a more precise account of financial reporting quality that separates signals of potential shifting from evidence of misclassification.

Keywords: Classification shifting, Corporate governance, Earnings management, Financial reporting quality, Research and development

INTRODUCTION

A company can report the same net profit as last year and still give readers a different account of how it earned that profit (McVay, 2006). In the setting studied by McVay (2006), an ordinary selling expense placed among special items raises the earnings attributable to the continuing business, even when every payment has been recorded and the accounts reconcile. On the income side, a gain outside the ordinary business, if reported as operating revenue, can make sales appear stronger without bringing in another customer (Malikov et al., 2018). For a shareholder trying to estimate what the business can earn next year, the distinction matters precisely because net profit gives no indication that the presentation has changed (Abdalla & Clubb, 2024).

In China the location of the disclosure itself changed in 2018, when the Ministry of Finance revised the general enterprise financial statement format for nonfinancial enterprises applying Chinese accounting standards, with provision for financial enterprises to adapt the format to their operations (Ministry of Finance of the People's Republic of China [MOF], 2018). Research and development expense, previously included in administrative expenses on the face of the income statement and disclosed separately in the notes in the setting studied,

became a separate line on the statement itself (Mohanram et al., 2025). An investor could now read the figure alongside other operating expenses, although management still had to decide how much of the cost of shared staff or facilities belonged to research (Mohanram et al., 2025).

Who can question such a classification, and what would give that person a reason to do so? Agency theory connects the cost of monitoring a manager with the information the manager controls and the interests of those who supply capital (Jensen & Meckling, 1976). In a company with a dominant shareholder, the question also concerns outside shareholders whose voting rights give them less influence over appointments and corporate decisions (H. A. Nguyen et al., 2021). Chinese evidence links the influence of the largest shareholder to real earnings management, with different associations for state control and managerial ownership (Dong et al., 2020). It would be premature to infer from that result alone how the same firms allocate research costs.

Filatotchev and Nakajima (2010) examine how governance inside a company interacts with pressures from its external environment. Drawing on that distinction, this article examines six possible sources of oversight. Within the company it considers independent directors, the financial independence of members of the former supervisory boards, and concentrated ownership. Outside the company it examines the external auditor, financial analysts and competition in the product market. Two Chinese studies address the classification decision directly. Luo et al. (2026) examined expense shifting and the choice of auditor among Shanghai and Shenzhen issuers, while Rehman et al. (2024) examined the presentation of nonoperating revenue. Other studies establish how a governance arrangement relates to accruals, operating decisions or innovation, each of which requires a separate argument before its findings can be applied to classification.

The unresolved issue is not whether governance matters to earnings management in general, but whether those responsible for oversight can detect the specific reporting choice that benefits management. Classification shifting can leave bottom-line earnings intact while changing a subtotal or a conspicuous expense line. Accordingly, a study of board independence using discretionary accruals cannot directly establish that directors prevent salary costs from being assigned to R&D. Nor can a positive association between institutional ownership and financial reporting quality show which income statement component became more reliable. A classification-specific analysis requires the incentive, the accounting boundary and the information available to a monitor to be considered together (McVay, 2006; Jensen & Meckling, 1976).

This article offers three contributions. It differentiates the accounting routes and the performance metrics they affect; it evaluates the strength of the evidence connecting governance arrangements to each route; and it develops propositions about the joint operation of oversight, ownership and outside scrutiny. The argument is anchored in Chinese listed firms, where state ownership, historically separate supervisory boards and the recent movement of supervisory responsibilities to audit committees' complicate comparisons across time (China Securities Regulatory Commission [CSRC], 2024). Unlike a general catalogue of governance mechanisms, the synthesis treats access to underlying records as a condition for effective intervention. It also separates legitimate classification judgments from managerial choices designed to mislead. The review does not estimate the prevalence of manipulation or claim that a reporting response demonstrates unlawful accounting.

LITERATURE REVIEW

To detect expense shifting empirically, McVay (2006) models expected core earnings and tests whether unexpectedly high core profit coincides with income-decreasing special items. Subsequent refinements address how special-item accruals affect these residuals, strengthening sample-level inference while still providing statistical evidence across observations rather than identifying the contents of a particular invoice (Abdalla & Clubb, 2024).

Turning to revenue, Malikov et al. (2018) examined 12,804 observations of UK listed firms over financial years from 1995 to 2014. The unit is a firm observed in a particular year, so a company can enter the sample more than once (Malikov et al., 2018). A study of 2,920 Chinese A share companies over 2003 to 2019 subsequently found evidence of a comparable pattern, particularly among firms reporting losses or low growth

(Rehman et al., 2024). Unlike transfers below core profit, reallocating costs between administrative and R&D expenses leaves operating profit unchanged, making traditional core-earnings models blind to within-operating-expense shifts (Mohanram et al., 2025)

Zang (2012) found that managers' choices between accrual manipulation and changes in operations were related to the relative costs of each approach. It follows as a research question that tighter oversight of one reporting choice could make another worth considering. The study did not estimate substitution into classification shifting (Zang, 2012). Evidence for that more specific argument calls for measures of the categories between which income or expenditure could move, along with information about the incentives attached to the resulting subtotal (Fan et al., 2019).

The same numerical change can result from legitimate accounting rather than earnings management. Revenue classification depends on the firm's ordinary activities and the economic substance of the transaction. Expense allocation also requires judgment when employees, software or facilities serve research and nonresearch functions. A supportable allocation reflects work performed, is consistent with the applicable accounting policy and can be reconciled to contemporaneous evidence. Opportunistic shifting instead occurs when management selects or revises a category primarily to misrepresent operating performance, growth or innovation rather than to reflect that substance (Healy & Wahlen, 1999; McVay, 2006). An incentive to cross a forecast threshold is not proof that the accounting was improper, just as an unusual expense ratio is not proof of deliberate misclassification. Analyses must therefore distinguish incentives, reported outcomes and substantiated accounting departures.

Capital market incentives, contract terms and regulatory decisions provide different reasons to exercise accounting discretion (Healy & Wahlen, 1999). For classification shifting, identifying a motive requires one further step. The category must enter a decision that matters to management. For some firms the decision turns on a forecast of core earnings (Athanasakou et al., 2009), for others on the amount of research an investor believes the firm has undertaken (Mohanram et al., 2025). A lender using net income would see the same number after a transfer between expenses already included in that calculation, whereas a lender using earnings adjusted to exclude selected charges could see an improvement (Fan et al., 2019).

Fan et al. (2019) address this point directly using private loan contracts tied to earnings before interest, taxes, depreciation and amortization, commonly abbreviated as EBITDA. When at least one relevant covenant was close to violation, firms appeared more likely to allocate core expenses to special items (Fan et al., 2019). The association was more pronounced among financially distressed firms close to an EBITDA covenant threshold (Fan et al., 2019). The definition in the contract matters here. If a charge remains in the lender's calculation after the reclassification, relabeling it brings the borrower no corresponding improvement in that measure.

China's R&D tax incentives provide a case where the item identified by a policy can matter substantially. Z. Chen et al. (2021) studied firms facing a threshold in reported R&D for a reduction in corporate income tax and found that both genuine investment and the relabelling of expenditure contributed to the observed response. Separately, guidance on China's additional deduction for qualifying R&D requires firms to distinguish production and operating costs from research expenditure and to maintain auxiliary records by project (STA, 2024). A number on the face of the income statement can direct attention to a claim, but entitlement depends on eligible activity and traceable costs (STA, 2024). The tax evidence and the reporting evidence therefore have distinct roles in explaining why managers might pay close attention to the R&D figure.

The distinction is especially material for R&D. If employees divide their working time between product development and routine administration, allocating documented hours to both functions may be appropriate. Transferring most salaries to R&D without corresponding project activity would raise a different concern. The State Taxation Administration's guidance on supporting records for R&D deductions offers one possible source of evidence about work and cost attribution, but tax qualification is not identical to recognition or presentation under financial reporting standards (State Taxation Administration of China [STA], 2024). Further, a decision to capitalise qualifying development expenditure changes recognition and potentially profit,

whereas a transfer between two expensed operating categories generally changes only the composition of operating expenses (MOF, 2024). Treating capitalization and relabeling as the same mechanism would confound the measured outcome.

Mohanram et al. (2025) found that the relative rise in reported R&D among nonstate firms after the reform was greater where industry peers exerted more pressure to invest in research and smaller where institutional investment was higher. They also documented a weaker positive valuation association for reported R&D, and lower innovation efficiency after the change (Mohanram et al., 2025). The findings are consistent with discretion in reporting and with some inefficient investment (Mohanram et al., 2025). How much of a given firm's increase came from additional research is harder to judge from its published accounts. For that question a monitor could compare the costs assigned to a project with its record of the work carried out (STA, 2024). Governance intervention is most credible when it connects this more prominent public line to private evidence about expenditure. Because investor attention, state control and industry peer pressure can change at the same time, observed post-reform increases should not be treated as direct measures of shifting. The central empirical question concerns the source of the increase, not merely its direction.

METHODOLOGY

This article adopts a focused narrative review to critically synthesize mechanisms and evidence rather than to estimate a pooled effect (Chaney, 2021). The starting body of work was the earnings-management and corporate-governance bibliography from the google scholar data base by keywords. It was supplemented by targeted consideration of classification-shifting studies, Chinese reporting research, and regulatory and professional documents relevant to the governance of accounting judgments. Sources consulted include peer-reviewed accounting and corporate-governance studies, one clearly identified working paper on product-market competition, and primary materials issued by the Chinese Ministry of Finance, China Securities Regulatory Commission, State Taxation Administration and auditing bodies. These sources serve different evidential purposes. Journal research provides tests of outcomes, while official documents establish obligations and institutional arrangements rather than evidence that a monitor enforced them.

The additional literature was identified through targeted scholarly discovery, publisher and DOI records, and references linked to central classification-shifting papers. The concepts guiding the supplementary reading were classification shifting, special items, unexpected core earnings, revenue reclassification, R&D presentation, auditor expertise, board and ownership monitoring, and Chinese listed firms. Relevance was assessed from the research question, institutional setting, outcome measure and, where available, the underlying methods. Priority was assigned to papers measuring a transfer between identifiable financial statement categories. China-specific studies were used preferentially for claims about its institutional environment; evidence from other markets was included when it sharpened or challenged a proposed mechanism. Research on discretionary accruals, real activities, innovation or valuation was retained only where it provided an explicit explanation of incentives, monitoring or an alternative interpretation, not as equivalent evidence of classification shifting.

For each substantive claim, the review asked what category was allegedly shifted, why the resulting number could benefit management, whether the outcome measure directly targeted that transfer, and which actor possessed the means to scrutinize the underlying transaction. Evidence is differentiated between classification-specific, but usually model-inferred, associations; indirect findings concerning related outcomes; and regulatory facts. Methodological appraisal considered construct validity, model dependence, alternative business explanations and possible endogeneity of governance choices. Selection of auditors, ownership structures and board members is rarely random. Even studies reporting plausible directional relationships may therefore be unable to distinguish monitoring from the characteristics of firms that choose stronger monitors. The synthesis accordingly draws theoretical implications without converting correlations into causal claims.

The process was purposive, not systematic. The google scholar keywords collection did not preserve a complete database query log, date-stamped screening decisions or counts of excluded records. No exhaustive search coverage, PRISMA flow diagram, formal quality score or statistical meta-analysis is claimed. This

limitation constrains generalizability and prevents numerical statements about the proportion of studies finding a particular effect. The more defensible goal is analytical transparency about why influential or directly relevant studies were prioritized and where extrapolation from adjacent research is necessary. In particular, the classification evidence is kept separate from research whose dependent variable is an accrual proxy or innovation measure.

FINDINGS

Board of Directors and Independent Directors

An independent director asked to approve the annual accounts faces a specific informational problem. Management can explain why a research project cost more than expected, but someone familiar with the project also needs to assess whether the employees whose time was charged to it worked on it. Chinese rules give independent directors a duty to oversee potential conflicts involving controlling shareholders and executives and permit them to request supplementary materials before a board meeting (CSRC, 2023). Those powers matter to classification when the disagreement concerns the allocation of an accepted cost. No unexplained discrepancy in the aggregate expense figure need draws the board's attention (Mohanram et al., 2025).

A director can meet a company's definition of independence while falling short of a more demanding test. Crespí-Cladera and Pascual-Fuster (2014) showed how the directors identified by the company could differ from those identified through a review of information available outside it. Fogel et al. (2021) considered a different attribute, the influence a director could exercise through professional and social connections. Firms with more influential independent directors exhibited greater chief executive accountability and less earnings management in their tests (Fogel et al., 2021). These directors' influence and credibility offer one explanation for their ability to challenge a senior executive (Fogel et al., 2021). Changes in their accounting knowledge would require a different measure.

Direct evidence from the UK offers a closer comparison. Zalata and Roberts (2016) related board and audit committee characteristics to the use of nonrecurring items in 713 firm year observations. Higher overall governance quality was associated with less classification shifting, and their results indicated a role for independence and tenure (Zalata & Roberts, 2016). The UK outcome was a transfer of expenses into nonrecurring items (Zalata & Roberts, 2016). To carry that finding over to Chinese R&D reporting, one would need to establish which directors receive information about cost allocations and whether their intervention is associated with a different allocation. An appointment alone cannot establish either part of that sequence.

Supervisory Boards and Institutional Transition

Financial independence is one proposed condition for effective supervision. Bai and Pan (2023) examined the economic independence of Chinese supervisory boards and found that firms with greater independence exhibited stronger innovation outcomes. Their evidence also associated this relationship with less diversion of resources by controlling parties (Bai & Pan, 2023). Their principal outcome was innovation (Bai & Pan, 2023). Attributing the result to improved verification of R&D expense would require evidence about how supervisors reviewed project accounts and whether the reported figures changed following that review. A company can produce more innovation and still have difficulty allocating overhead between activities.

Pay and expertise capture different features of a supervisor's position. In Chinese listed firms, Ran et al. (2015) found that accounting or academic backgrounds among supervisors, as well as supervisor compensation, were associated with higher accounting information quality. An unpaid supervisor may have fewer direct financial ties to management, but a record of zero pay from the listed company does not establish who selected that person, which interests the person represented or how much time they committed to the work. As an empirical design choice, remuneration should therefore be recorded separately from qualifications, the source of appointment and access to project information. This would allow the proposed effect of economic independence to be examined without treating unremunerated work as evidence of effective supervision.

The two Chinese supervisory findings cannot be read as a direct test of classification shifting. Accounting information quality is a broader construct than whether salary costs were placed in the correct line, and innovation outcomes can improve even when the administrative and R&D accounts are poorly reconciled (Ran et al., 2015; Bai & Pan, 2023). Likewise, compensation provides an imperfect measure of economic independence, because a supervisor's appointment, relationships and access to internal documentation may matter more than the recorded amount of pay. China's transfer of supervisory powers to audit committees further changes the interpretation of these variables across periods (CSRC, 2024). A governance coefficient is useful only if the institutional authority and the accounting decision it could plausibly affect are aligned.

Ownership Concentration and Owner Identity

A large shareholding gives its owner a financial reason to monitor decisions that reduce the value of the company, although the benefits of monitoring need not accrue equally to everyone who holds shares (Jensen & Meckling, 1976). Pandey and Sahu (2021) examined concentration and agency costs in Indian manufacturing firms. Their setting draws attention to a distinction that also matters in China, between having enough votes to challenge an executive and having an incentive to do so on behalf of outside investors. A study that records the largest shareholder's stake captures part of the first issue. The percentage alone says little about the benefit that owner expects from a particular presentation of earnings.

Portuguese evidence supports the monitoring interpretation in one setting. Alves (2012) observed lower discretionary accruals in firms with more concentrated ownership in a sample of 34 nonfinancial listed companies. Alhadab et al. (2020) likewise found that ownership concentration was associated with less accrual management and fewer related party transactions among Jordanian industrial issuers. In Egypt, Abousamak and Shahwan (2018) found a negative relationship for one measure but characterised the results for ownership concentration as inconclusive across specifications. Pooling these findings under a single expectation about ownership would discard the distinction between accruals and transactions with related parties, as well as the different institutional settings.

Evidence from Vietnam points in the other direction. H. A. Nguyen et al. (2021) found a positive association between concentration and earnings management among 489 nonfinancial issuers, while managerial and foreign ownership had different associations. Ung et al. (2018) analysed Malaysian property companies, where brokerage fees and the ownership structure were relevant to earnings management in a particular industry. For China, Dong et al. (2020) found that companies with more influential largest shareholders were more likely to exhibit real earnings management, whereas state control and managerial ownership helped mitigate the incentives to use it. These results support investigating the identity and role of the owner alongside the concentration of the shareholding. They do not give an expected sign for R&D expense shifting in every Chinese issuer.

In the R&D setting, a substantial owner may be able to obtain a breakdown of research spending at relatively low cost. Whether it wants that breakdown disclosed to outside shareholders is a different question. Mohanram et al. (2025) found a smaller increase in reported R&D after the format change among firms with greater institutional investment. The institutional holdings measured by Mohanram et al. (2025) can overlap with the largest shareholding analysed by Dong et al. (2020), but the measures answer different questions about who owns the company and who controls it. A test of concentration would therefore need to identify who holds the controlling stake and distinguish an effect on reported research expense from any change in research actually undertaken.

Mixed ownership findings therefore have theoretical content rather than being evidence of mere inconsistency. A large blockholder can reduce information costs and demand detailed cost records yet may also derive private benefits from presenting strong reported sales or innovation expenditure. Institutional investment may provide more independent scrutiny, although its association with R&D reporting could reflect investment selection or pre-existing firm quality rather than direct intervention (Dong et al., 2020; Mohanram et al., 2025). State ownership is another source of heterogeneity because managerial assessments and financing constraints may

not mirror those of nonstate companies. What matters is the alignment of monitoring incentives with outside shareholders, not simply the proportion of shares owned by the largest investor.

External Auditing

External auditors express an opinion on a complete set of financial statements (International Auditing and Assurance Standards Board [IAASB], 2015). During an engagement, an auditor can examine records supporting the allocation of an expense and seek evidence that corroborates or contradicts management's account (Chinese Institute of Certified Public Accountants [CICPA], 2023). The audit opinion concerns the financial statements as a whole, which limits what a reader can infer from it about the treatment of an individual employee's time (IAASB, 2015). Azzam et al. (2020) examined the relationship between internal and external auditing and reporting quality in Jordan. Their study helps situate the external audit alongside internal review, while the audit standard provides the basis for describing the auditor's formal reporting responsibility (IAASB, 2015).

Big Four status is an imperfect indicator of classification-specific audit quality. International evidence links Big Four auditors with less accrual and real earnings management in some settings, while a Pakistani study reports no comparable difference (Choi et al., 2018; Abid et al., 2018). Tracking audit partners across firms also points to client selection, learning and engagement resources as possible explanations of observed audit quality (Che et al., 2020). None of these findings alone establishes that an auditor tested the allocation of an individual R&D cost.

More direct evidence is available for China. Using Shanghai and Shenzhen A share data from 2008 to 2022, Luo et al. (2026) found less expense shifting among firms that employed a higher tier auditor than their characteristics predicted and more where the auditor was of a lower tier than expected. Auditor industry expertise accounted for part of the relationship, and internal control quality moderated it (Luo et al., 2026). Their measure relies on unexpectedly high core earnings (Luo et al., 2026). An auditor investigating a transfer within operating expenses faces a different problem, since tracing how overhead or a salary was divided between projects may require evidence at the project level (CICPA, 2023).

The contrast between auditor brand and audit capability is especially relevant to classification. Audit opinion quality is not a transaction-level judgment on every component disclosed in the financial statements. Large-firm affiliation may capture personnel, training and reputation, but sector knowledge and access to usable supporting records are closer to the mechanism of detecting an implausible cost assignment (CICPA, 2023; Che et al., 2020). Luo et al. (2026) provide classification-specific Chinese evidence, including the role of industry expertise and internal controls. Still, their dependent variable is an inferred special-item pattern rather than a documented transfer from an administrative account into an R&D project. Auditor tier and client characteristics may also be jointly determined. A causal interpretation would require an identification strategy that addresses why a particular client selected that auditor.

Financial Analysts and Product Market Competition

The evidence differs across markets and across the outcomes analysts might monitor. Degeorge et al. (2013) found that increases in coverage were associated with less earnings management in countries with more developed financial systems. Miranda et al. (2018) linked analyst following to lower earnings management after periods of optimism in Brazil. C. C. S. Chen et al. (2020) observed less earnings management among internationally cross listed firms with more analyst following, and S. Li et al. (2022) reported a negative association between coverage and real earnings management among Chinese companies. The Chinese study also examined firms meeting or beating earnings benchmarks, and its result concerns decisions about actual operations, leaving the presentation of the resulting costs to be tested separately (S. Li et al., 2022).

A widely followed forecast can itself give management a target (Athanasakou et al., 2009). Athanasakou et al. (2009) documented shifting by some larger firms close to a forecast threshold, and also showed how downward forecast guidance could make the target easier to reach. Qian et al. (2019) examined a different

form of short term pressure, finding that a reduction in analyst coverage following US broker mergers or closures was followed by better corporate social performance. The outcome was social performance, so the study supplies no estimate of the share price penalty for missing an earnings forecast (Qian et al., 2019).

Competitive pressure can impose a cost on poor management even if a competitor has no access to the firm's accounts (Chou et al., 2011). Chou et al. (2011) examined the role of competition in disciplining management and its relation to internal governance. Doan (2022) found less earnings management among Vietnamese firms facing stronger competition, and Sanusi et al. (2023) found a negative association between competition and real earnings management in Indonesia. In the latter study the firm's own market power had no significant relation with real earnings management (Sanusi et al., 2023). The distinction between competitors' pressure on a firm and that firm's ability to set terms in its market can therefore change the interpretation of the results (Sanusi et al., 2023).

Methodological Limitations: Measurement Error and Endogeneity

Across these literatures, measurement differences are as important as the sign of a coefficient. The original special-item model links unexpectedly high core earnings to income-decreasing special items, but the estimated residual depends on controls for ordinary performance. Abdalla and Clubb (2024) show that the treatment of special-item-related accruals can affect measured shifting; their refinements strengthen the basis for inference at a sample level without identifying the intention behind any particular expense.

Revenue reclassification studies face a parallel construct problem because the boundary between operating and nonoperating income may change with a firm's business model (Malikov et al., 2018; Rehman et al., 2024). In the R&D setting, reported growth may reflect new projects, reallocated shared costs or lower-productivity innovation. Patents, site visits and valuation responses can help assess consequences but do not identify the cost ledger from which expenditure moved (Mohanram et al., 2025).

The same caution applies to observational governance estimates. An effective auditor may attract conservative clients; a board may appoint financial experts after a reporting problem; analyst coverage may expand because financial performance has improved. Regression controls and fixed effects reduce some confounding but do not establish that the governance mechanism caused a different classification.

Evidence is strongest when the putative transfer, the governance intervention and a plausible source of exogenous change are all observed. Findings on real earnings management and discretionary accruals remain useful for motivation and comparative theory, but the outcome must not silently change between the cited result and the claim being made (Choi et al., 2018; S. Li et al., 2022; Dong et al., 2020).

DISCUSSION

The conceptual contribution is a sequential account of classification-specific monitoring. It begins with a source and destination in the income statement, such as ordinary expenses to special items, incidental gains to operating revenue, or administration to R&D. The second element is the measure rewarded by a contract, forecast, valuation narrative or policy threshold. The third is the governance actor's incentive and authority to challenge that allocation.

The fourth is verification capacity, comprising information rights, accounting or industry expertise, reliable project records and willingness to escalate discrepancies. Only where these elements connect should governance be expected to constrain misleading presentation. An apparently strong board may be effective against nonrecurring-item shifts but ineffective against within-operating-cost reallocations that escape its normal reports. Table 1 summarizes this logic as an interpretive framework rather than an estimated model (Jensen & Meckling, 1976; Filatotchev & Nakajima, 2010).

Table 1. A classification-specific governance framework

Reporting transfer	Rewarded measure	Verification and relevant monitors	Interpretive implication
Recurring expenses to special items	Core earnings or covenant-adjusted performance	Board/audit committee and auditor examine exceptional charges against invoices and operating activity	Core-profit effects may occur without a change in net income
Nonoperating gains to operating revenue	Sales growth and operating performance	Auditor, board and analysts examine contracts, business activity and income source	Operating revenue may change without new sales
Administration to expensed R&D	R&D intensity and innovation signalling	Specialist auditor, audit committee and owners check project hours, payroll and overhead methods	Operating profit may not change; genuine R&D and reclassification must be distinguished

Note. These are conceptual pathways; they do not imply verified misclassification or estimated causal effects.

Interactions follow naturally from that sequence. An independent audit committee that can commission examination of a cost allocation may convert an auditor's sector knowledge into effective challenge; absent committee support, the same auditor may lack the organizational leverage to correct a contested judgment. Conversely, active oversight without access to time records or contract evidence may produce formality rather than detection. Evidence on powerful directors, internal controls and industry-specialist auditors is consistent with the plausibility of these channels but does not yet establish their joint causal effect on verified R&D allocations (Fogel et al., 2021; Luo et al., 2026). The framework therefore predicts complementarities conditional on access, not a mechanical benefit from adding independent directors or purchasing a higher-tier audit label.

Ownership can amplify or frustrate this complementarity. A substantial shareholder may obtain detailed expenditure records and insist on credible reporting to protect long-run value. That same access can also make it easier to suppress an independent challenge when an inflated growth narrative serves a financing, control or political objective. Independent institutional shareholders could strengthen an audit committee's bargaining position, while concentrated insider control could weaken it. The contrasting associations reported for Chinese real earnings management and the dampened post-reform R&D increase in firms with greater institutional investment justify conditional rather than universal predictions (Dong et al., 2020; Mohanram et al., 2025). The empirical design must identify who controls votes, who benefits from a particular reported figure and whether that party can influence the monitoring body.

External scrutiny is similarly ambiguous. Analysts can question unusual changes and encourage better disclosure, but a widely observed forecast also establishes the benchmark management may try to meet. Classification shifting is most attractive when it changes the measure analysts are judging. Pressure to meet core earnings may favour special-item transfers, while attention to reported innovation intensity could create incentives for increasing the R&D line. Product-market rivalry can discipline operating efficiency and simultaneously raise the value of an innovation signal.

This reasoning leads to six propositions, stated as hypotheses for future empirical tests rather than outcomes demonstrated by this review. P1 predicts that the association between governance quality and suspected shifting will differ across source to destination pairs; safeguards effective for special items need not govern transfers between administration and R&D. P2 predicts that independent board or audit-committee oversight will have a stronger negative association with unsupported classification shifting when the auditor possesses relevant industry expertise and both parties can inspect supporting records. The distinctive element is the interaction between authority and evidence, not independence or reputation taken alone. Tests could compare settings with similar stated governance independence but demonstrably different access to accounting documentation.

P3 predicts that concentrated ownership's association with suspected shifting will be moderated by the identity and incentives of the controlling shareholder. The restraining effect of board and auditor scrutiny should be stronger where independent institutions exert meaningful influence, but weaker where a controlling party benefits from a favourable subtotal or innovation signal. P4 predicts that analyst following will constrain suspected classification shifting when analysts are able to verify the affected component, while proximity to a salient core-earnings benchmark may weaken or reverse that relationship. Peer R&D pressure and competition should be examined as moderators of the payoff from reporting innovation rather than assumed to carry a uniform effect (Athanasakou et al., 2009; Mohanram et al., 2025).

P5 predicts that, among firms experiencing an unusual rise in reported R&D after separate presentation, those subject to credible project-level verification will exhibit fewer unsupported transfers from administrative expense than otherwise comparable firms. The proposition cannot be tested by the reported R&D increase alone. P6 predicts that the movement of statutory supervisory functions to audit committees will preserve or improve classification reliability only where independent accounting expertise, information access and escalation procedures are maintained in substance. A firm that abolishes its supervisory board but retains the same competent reviewers is analytically different from one that relocates formal responsibility without preserving monitoring capability (CSRC, 2024).

Empirical extensions should start with the accounting bridge that the hypothesis concerns. Special-item research can contrast conventional unexpected-core-earnings estimates with sensitivity tests informed by Abdalla and Clubb (2024), including the handling of special-item accruals and subsequent performance. Revenue research can track the transaction source alongside changes in segments and the firm's ordinary operating activities. R&D research would ideally reconcile expense-line disclosures with employee time allocation, shared-overhead methodologies, project documentation, corrections and, where substantively comparable, tax-supporting schedules. It should separately observe capitalised development expenditure. A firm-level residual or unusually high R&D-to-assets ratio is a screening signal, not a validated amount of misclassification.

Research on Chinese policy changes also requires defensible counterfactuals. Pre-2018 R&D expense should be reconstructed from notes where disclosed, not coded as zero simply because it was not shown as an income-statement line. Staggered adoption of new monitoring arrangements might allow comparisons within issuers, subject to documentation of implementation dates, parallel trends and simultaneous reforms. Auditor changes or independent-director appointments offer further variation but are endogenous unless their timing or causes are credibly addressed. Analysts, ownership and project investment may change alongside the intervention. Designs that combine category-specific proxies with independently verified allocation records would make stronger claims than a regression of broad governance indices on generic earnings-management measures (MOF, 2018; Mohanram et al., 2025; Luo et al., 2026).

These tests would also clarify what governance success means. A reduction in an abnormal-core-earnings score is not necessarily an improvement in R&D reporting, and lower disclosed R&D is not inherently higher quality. Effective governance should produce classifications that correspond more closely to the underlying activities and permit users to interpret the intended performance measure. That outcome may involve revising an unsupported charge, documenting a valid reallocation or explaining genuine changes in the firm's research programme. A careful study would retain all three possibilities rather than treating every managerial judgment

as opportunistic. Such discriminating evidence is currently thinner for intra-operating-expense transfers than for special-item shifting, leaving a substantive contribution available to future Chinese research.

CONCLUSION

Classification shifting cannot be assessed as a single earnings-management technique with a single governance response. Moving an operating expense into a special item, presenting incidental income as revenue and reallocating administration to R&D affect different figures, create different managerial rewards and require different supporting evidence. The Chinese literature directly documents some classification-specific patterns and shows why the presentation of R&D attracts managerial and investor attention. It does not establish that an unusual R&D increase necessarily reflects a misclassified cost (Rehman et al., 2024; Mohanram et al., 2025; Luo et al., 2026).

The review's central proposition is that oversight matters when the monitor has an incentive to challenge the affected measure and a practical route to verifying the underlying transaction. Board and audit-committee independence, owner identity, auditor expertise and market scrutiny may reinforce or offset one another. The review is purposive and most empirical studies rely on indirect, observational measures, so its conclusions should be read as a classification-specific theory and research agenda rather than causal estimates. Future studies that pair well-identified governance changes with transaction- or project-level validation can determine when apparently better reporting reflects genuine activity, compliant judgment or opportunistic reclassification.

Ethical Approval

This narrative review uses published studies and publicly accessible professional or regulatory materials. It involved no human participants, intervention or collection of identifiable private information; formal participant-related ethics approval was not required.

Conflict of Interest

The authors declare no conflicts of interest related to this review.

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