ABSTRACT

We study a firm's decision to classify transactions as recurring or nonrecurring in a setting with no fixed classification scheme, but with the following principle: recurring transactions must be more persistent than nonrecurring ones. We find that market prices are more informative under principles-based classifications than they would be under a hypothetical, optimally chosen specific classification rule. Consistent with archival studies on classification, our findings show that equilibrium classifications depend on the levels of income-increasing and income-reducing items. In fact, it is because of this property that classifications are informative.