Accounting Alchemy

Robert E. Verrecchia

The Wharton School

University of Pennsylvania

Philadelphia, PA USA 19104-6365

Thesis

- Considerable anecdotal evidence that firms exhibit heuristic behavior in computations of earnings under US-GAAP
- Evidence suggests that firms *believe* that markets cannot see through transparently cosmetic improvements in earnings
- This impedes all manner of things, but in particular accounting regulation that involves fair value accounting

Some terms defined

- "Heuristic" suggests a type of learned or associated knowledge
  - A manager learns or associates accounting measures of firm performance with real economic achievement, and thus has difficulty disentangling the two
- "Belief" emphasized because no claim made that markets are actually fooled by cosmetic improvements – firms simply believe this to be the case
- Note the word "transparent" – firms believe that markets cannot see through cosmetic improvements that are *transparent*
  - This is distinct from earnings management, which suggests manipulations to earnings that are difficult to decipher

Three claims

- Major accounting controversies that arise from the choice among accounting alternatives in general have little to do with the welfare aspects of a particular choice
  - Rather, the controversies arise from a narrow concern as to whether a choice requires the recognition of less revenue, more expense, and/or more earnings volatility
- Firms have difficulty disentangling accounting measures of performance from real economic achievement
  - Firms simply believe that higher/smoother earnings create wealth
- Heuristic behavior with regard to earnings is rarely acknowledged

Heuristic behavior

- Not acknowledged by regulators because of the politically sensitive nature of regulation
  - Accounting pronouncements under US-GAAP have the appearance of being “gerrymandered”
- Not acknowledged by economists because of unfamiliarity with the nuanced way in which accounting standards are written and interpreted
- Not acknowledged even among academic accounting researchers because it is more expedient to assume that firms, investors, and markets are rational

Heuristic behavior and earnings

- Heuristic behavior manifest primarily in computation of earnings in a Statement of Net Income, as distinct from other financial statements and/or disclosure in the financial notes
- Firms place disproportionate emphasis on the avoidance of fair value accounting in computations of earnings, despite being seemingly indifferent to its use in *other* financial statements and its comprehensive disclosure in the financial notes
- Why should this be the case?
  - Disclosure versus recognition debate

Employee stock options

- APB Opinion No. 25, *Accounting for Stock Issued to Employees*, required that employee stock options be measured based on the "intrinsic value" of the option at the date of the grant (1972)
- FASB Statement No. 123, *Accounting for Stock-Based Compensation*, only *suggested* expensing the fair value of employee stock options (1995)
- In 2001 only two companies in the S&P 500 accounted for their employee stock options at fair value despite extensive disclosures accompanying the use of "intrinsic value"

Goodwill amortization

- APB Opinion No. 16, *Business Combinations*, permitted both the Purchase and Pooling methods for mergers, but attempted to limit the use of the latter (1970)
- FASB Statement No. 141, *Business Combinations*, eliminated the use of Pooling to account for a business combination (2001)
- FASB in Statement No. 142, *Goodwill and Other Intangible Assets*, no longer required the amortization of Goodwill (2001)
  - In conjunction with the elimination of a hugely popular accounting technique that avoided Goodwill amortization – Pooling – the FASB eliminated the most objectionable feature of the alternative – Purchase – by no longer requiring that Goodwill that arises from a Purchase be amortized!

Income smoothing

- Firms believe that "smooth earnings" creates wealth
- Other Comprehensive Income (OCI) excludes fair value adjustments from earnings
- OCI employed primarily in
  - FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (1993)
  - FASB Statement No. 52, *Foreign Currency Translation* (1981)

Explanations

Commonly cited explanations fail to explain the totality of the evidence

- Investors are “functionally fixed” on earnings
- Contracts are written over accounting earnings
- Financial footnotes are perfunctory and thus ignored

Economic-based explanations

- Managers are caught in a “prisoner’s dilemma” in which markets expect managers to inflate earnings
- Reservations about this explanation
  - Assumes managers intend to mislead the market about their firms’ worth and so *know* that they are not creating wealth when they inflate earnings
  - Relies critically on earnings’ manipulations being opaque

My explanation

Managers are heuristic

- Managers learn to associate, and thus ultimately believe without reservation, that improvements in accounting measures of performance create wealth, regardless of how the performance is measured or achieved

Conclusion

Why so little attention paid to heuristic behavior associated with earnings when its effect on accounting regulation is so substantial?