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Do FASB's Extended Adoption Windows Provide to Managers a Sandbox in Which
They Can Play with Their Earnings?

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Introduction

Reliable financial information is one cornerstone of a successful market economy in that it allows successful firms to distinguish themselves from poor performers (Healy & Whalen, 1999). Indeed, Enron has undoubtedly reminded the financial community of the critical importance reliable financial information plays in affecting the success of the capital markets. Unfortunately, managers' goals (i.e., maximizing bonuses or performance ratings [Guidy et al, 1999]) often conflict with financial statement users' goals (e.g., receiving financial information that is verifiable, neutral, and representationally faithful). As a result, published financial statements often reflect a certain degree of "earnings management" (e.g., Bruns and Merchant, 1990).

Past research suggests that extended adoption windows associated with new FASB pronouncements provide to companies an additional tool they can use to manage earnings (Gujarathi & Hoskin, 1992). Extended adoption windows can afford management the opportunity to adopt a standard early, either when the effects of the change in accounting principle are positive and will enhance reported earnings, or when the effects of the change in accounting principle are severely negative and will further reduce earnings in a poor year (i.e., the "big bath theory" [Kinney and Trezevant, 1997]).

In light of these results, it is not surprising that leaders from both the professional and academic communities have begun to question the ethics of earnings management and the extent to which managers should be allowed to use judgment in reporting earnings. Schipper (1989), for example, questions whether accounting rules should "be

promulgated in such a way that opportunities for earnings management are eliminated” to reduce the opportunities companies have to engage in earnings management. Similarly, James Leisenring, while still a member of the FASB remarked, “we can’t give the preparer community a sandbox in which to play with their earnings” (1994). Despite these suggestions, recent FASB pronouncements have afforded preparers an extended adoption window, allowing them the opportunity to “early adopt” statement provisions.

Previous studies have looked for evidence of earnings management in early adoption, or reported about the market effects of early adoption. We consider here not only managements’ decision to become an early adopter of a new standard, but also how that decision is affected by market expectations of bad news and investor tolerance for earnings management, and the ramifications of the early adoption decision for standard setting. Specifically, in this exploratory study, we examine managers’ propensity to early-adopt the provisions of SFAS 142, Goodwill and Other Intangible Assets (FASB, 2001) in light of differing levels of market acceptance of bad news and tolerance for earnings management.

This example provides an especially interesting study of the early adoption decision for two reasons. First, in large part owing to the complexity of the new standard, FASB expected very few companies to early adopt the provisions of SFAS 142. This suggests that those companies early adopting the provisions of SFAS 142 had not only the resources, but also a compelling reason to do so. Second, because the early adoption window spans the September 11, 2001 terrorist attacks, the Enron collapse, and their related effects on the economy there were differences in the market’s expectation for bad news as well as investors’ tolerance for earnings management. As a result, we question

whether management's decision to early adopt or not to early adopt SFAS 142 was affected by the economic and political fallout from these unique events, and evaluate the FASB's extended adoption policy in light of the results. The rest of the paper is organized as follows: we briefly review relevant literature in the next section; we analyze an exploratory sample of early adopters of SFAS 142 in the section following that; and we conclude with a discussion evaluating FASB's policy of allowing extended adoption windows.

Literature Review

Earnings Management

According to Healy and Whalen (1999, 368), "Earnings management occurs when managers use judgment in financial reporting...to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." This definition implies that managers' actions to mislead shareholders are deliberate and therefore contain an ethical dimension (e.g., Blasi 1980). Indeed, because Healy and Whalen (1999) report that at least some investors appear to be fooled by the earnings management, the practice cannot be perceived as neutral.

In like manner, the SEC does not view earnings management in a neutral light. Then-chairman of the SEC, Arthur Levitt, declared "war" on earnings management in a September 1998 speech in New York to a group of CPAs, lawyers and academics (Loomis, 1999). According to Loomis, the key problem associated with earnings management is that it obscures facts about the business. Indeed, earnings management is

particularly problematic during economic downturns when it can hide the fact that the company is in severe financial difficulty.

Although the accounting literature does not focus on the ethical dimension of the early-adoption decision, it generally recognizes the existence of earnings management. Ronen and Sadan's (1981) landmark study on income smoothing provides conclusive evidence of the practice. More recently, Healy and Wahlen's (1999) review of the earnings management research reports that there is evidence that companies "window-dress financial statements prior to public securities' offerings, to increase corporate managers' compensation and job security, to avoid violating lending contracts, or to reduce regulatory costs or to increase regulatory benefits" (p. 371). Unfortunately, while Healy and Wahlen provide information about the specific accruals that are most prone to earnings management, they do not report about the association between earnings management and the decision choice involved in managers' decision to early adopt (or not early adopt) the provisions of newly issued FASB statements.

Early Adoption and Earnings Management

In recent years, the FASB has passed standards with multi-year adoption windows, allowing managers the discretion to select early adoption. For instance, SFAS 87 allowed a five-year adoption window; SFAS 96 allowed a five-year adoption window after various extensions; SFAS 106 allowed a four-year adoption window (Amir & Zev, 1997a); and SFAS 133 allowed a three-year adoption window. Most recently, the FASB has again allowed a multi-year adoption window for SFAS 142. As reported above, Gujarathi and Hoskin (1992) suggest this policy provides to preparers an additional tool managers can use to manage earnings. Unfortunately, prior research analyzes only the

financial statement effects of the early adoption of many of these extended adoption statements and not whether market acceptance of bad news or investors' tolerance for earnings management associate with managers' propensity to manage earnings using the early adoption decision. In most cases, the studies have found that companies who adopt standards early do so to boost reported earnings.

However, not all early adopters boost their earnings by the change in accounting. For these companies, two alternative earnings management techniques may explain their decisions to adopt early. The "big bath" theory (Kinney and Trezevant, 1997) suggests that in particularly bad earnings years, management may choose to report additional bad news, so as to create a situation in which the next period's results will almost certainly be an improvement. The existence of the big bath has been borne out in the literature. Elliott and Shaw's (1988) study of discretionary write-offs supported the theory, as did Healy's (1985) study of management bonuses. Alternatively, McNichols and Wilson (1988) suggest that some companies may purposely report bad news in extremely good earnings years so as to smooth out the earnings stream over time.

SFAS 87

In separate studies of early adopters of SFAS 87 on pensions, Norton (1988), Stone and Ingram (1988), and Senteney and Strawser (1990) all find that the early adopters were able to drastically reduce current pension expense by adopting the new standard. Similarly, in a test of eight reasons for the early adoption of SFAS 87, Langer and Lev (1993) find that the only way to discriminate between early and late adopters was that the early adopters increased reported earnings.

SFAS 96

Gujarathi and Hoskin (1992) find further evidence of earnings management in a review of the early adoption for SFAS 96 on deferred income taxes: they find that for the vast majority of their sample companies, earnings were increased by early adoption of the provisions of SFAS 96. Similarly, Simon and Costigan (1996) find a positive effect on current year's income for 70% of companies that chose to early-adopt the provisions of SFAS 96, and that this group was more highly leveraged and more likely to have suffered an earnings decline than a control group.

SFAS 106

Costello et al (1994) review the effect of early adoption of SFAS 106 on Other Post-Employment Benefits (OPEB) for sixty-one early adopters. Results in their study differed in several ways from those reported in the studies above. First, they found that fewer firms were early adopters for SFAS 106 than for other standards that offered early adoption. They offered two possible explanations for this. One, a large amount of data needed to be gathered in order to implement the standard, limiting the option of adopting early to larger firms. (This was consistent with findings from Senteney and Strawser [1990] as well as Langer and Lev [1993] indicating that size is a factor in the decision to early adopt because larger firms have a greater ability to use consultants and generate internal data.) Two, Costello et al. (1994) suggest the possibility that fewer firms were early adopters for SFAS 106 because the effect on earnings of adopting SFAS 106 was negative for almost all companies, so that the primary incentive for early adoption noted above, to boost reported earnings, did not apply.

Second, Costello et al (1994) find that most early adopters had smaller than average pension obligations, and that 25% of their sample of early adopters used a higher

than average discount rate in order to reduce the amount of the obligation to be recorded. This was somewhat consistent with the boosting earnings theory.

Finally, twenty of the fifty-four sample companies that chose to recognize the full transition obligation in the year of adoption would have reported a net loss even without the effects of the accounting change. This finding provides support for the big bath theory.

Amir and Ziv (1997b) confirm the findings of Costello et al. (1994) with respect to early adoption of SFAS 106. That is, in Amir and Ziv's (1997b) study, firms with favorable information to report to the market as a result of the accounting change, relative to other firms, were more likely to be early adopters. This suggests the importance of boosting earnings in management's decision to early-adopt the provisions of SFAS 106.

Earnings Management and Accounting Ethics

Merchant and Rockness (1994) were among the first to analyze the ethics of earnings management. They concluded that earnings management was "probably the most important ethical issue facing the accounting profession" (p. 92). Despite this, research finds that opinions on the acceptability of earnings management vary considerably. Both Bruns and Merchants (1990) and Fischer and Rosenzweig (1994) find that the groups included in their surveys (students as well as practitioners) had greater tolerance for operating expense manipulation than accounting manipulation. More recently, in a test in which MBA students were assigned the role of either manager or shareholder, Kaplan (2001) reports inconclusive results.

Based on our review of the literature, the evidence suggests companies early-adopt the provisions of new FASB standards for one of three reasons. The first and most

likely reason companies choose to early-adopt the provisions of new FASB standards is to boost reported earnings. Secondary reasons for early adoptions are to enhance reported losses (i.e., take a “big bath”), or to reduce reported earnings in an otherwise particularly good year (i.e., to smooth income). Indeed, in a review of a large sample of companies reporting “special items”¹ over the ten years from 1981-1991, Kinney and Trezevant (1997) provide evidence that all three of these earnings management techniques – reporting items so as to boost earnings, to contribute to a big bath or, to smooth earnings – are in use. The big bath results, they suggest, because companies facing large earnings declines often cannot find enough special items with positive income impact to recognize in order to boost earnings as desired, (Kinney and Trezevant, 1997).

Despite these findings, no study considers the impact of market acceptance of “bad news” on managers’ decisions to early adopt an accounting standard. There is evidence that the preparer community manages earnings to meet earnings forecasts (e.g., Kasznik, 1999) which suggests that market expectations for “bad news” may associate with managers’ propensity to engage in earnings management. That is, managers’ propensity to report negative financial information may increase as market expectations of negative results (i.e., “bad news”) increases. We investigate here whether market expectations about reported results affect managers’ propensity to early adopt the provisions of a newly issued FASB statement. Formally stated, Research Question 1 is:

Research Question 1: Does level of market acceptance of “bad news” affect managers’ propensity to early adopt the provisions of an accounting standard?

¹ Special items are those that are either infrequent or unusual, but not both.

Further, despite recognition that investors tolerate a certain amount of earnings management (e.g., Healy and Wahlen 1999), prior research fails to consider whether investor tolerance for earnings management associate with managers' decision to adopt a new FASB statement early. That is, one might expect a positive association between managers' propensity to engage in earnings management and investor tolerance for earnings management. Accordingly, in this paper, we investigate whether investor tolerance for earnings management affect managers' propensity to early adopt the provisions of a newly issued FASB statement. Formally stated, Research Question 2 is:

Research Question 2: Does level of investor tolerance for earnings management affect managers' propensity to early adopt the provisions of an accounting standard?

In investigating these questions, it is important for us to also consider the effects of other factors previously associated with earnings management in the literature. For instance, because results in the literature (e.g., Amir and Ziv, 1997b; Costello et al, 1994; Langer and Lev, 1993; Simon and Costigan, 1996) suggest the company's ex ante financial picture together with the direction of the impact of adopting the new FASB standard may interact in affecting the propensity of managers to early adopt the provisions of a new standard, care must be taken to consider these factors in our investigation.

In addition, it is important for us to also consider company size. That is, prior research indicates that the more complex the new standard, the more time and expertise that may be required for adoption (e.g., Costello et al., 1994; Langer and Lev, 1993; Senteney and Strawser, 1990). This suggests that larger companies with greater financial

resources may have more flexibility than smaller companies in choosing to early-adopt newly issued FASB pronouncements.

An Exploratory Sample of Early Adopters of SFAS 142

Sample Selection

To assess the degree to which managers decisions to early-adopt the provisions of a new FASB standard relate to market acceptance of bad news and investor tolerance for earnings management, we undertook an exploratory study of companies early adopting the provisions of SFAS 142, Goodwill and Other Intangible Assets (FASB, 2001).² The study became markedly more interesting when the terrorist attacks of September 11, 2001 and the collapse of Enron both occurred during its early adoption window. This afforded us the opportunity to study previously unstudied aspects of earnings management using early adoption. Market acceptance of bad news could be assessed in the pre/post September 11th periods, while investor tolerance for earnings management could be assessed in the pre/post Enron periods.

For instance, an August 18, 2001 AP Newswire story reporting about the day's market activity concluded, "The sharp sell-off [today] was an indication that investors are relinquishing their hopes that business will get better by the end of 2001" (Baldwin, 2001: <http://detnews.com/2001/business/0108/20/-272223.htm>). This headline suggests that in August, investors were prepared for "bad news" about corporate profits. After the terrorist attacks of September 11, 2001, there was another sharp sell-off of stock (Tsao, 2001), suggesting that in the post-September 11th period investors were even more prepared for "bad news" about corporate profits than they were prior to the pre-

² We chose to examine early-adopters for SFAS 142 because the FASB had initially expected few early adoptions of this standard as a result of the impact on earnings of expected impairment losses.

September 11th time period. Accordingly, the post-September 11th period represents a period of higher tolerance for “bad news” than the pre-September 11th period. As a result, we evaluate Research Question 1 by investigating those companies who announced early-adoption of the provisions of SFAS before and after September 11, 2001.

Although the Enron collapse began unraveling prior to October 31, 2001 when the SEC inquiry was upgraded to a formal investigation (Knox, 2001), onset of the formal SEC investigation brought to light the role accounting and reporting irregularities played in the company’s demise. As a result of the negative publicity attached to accounting shenanigans associated with Enron’s collapse, investors would expect higher quality financial information in the period following October 31 than they would in the period prior to October 31, 2001. That is, investors would likely tolerate more earnings management in the period prior to October 31, 2001 than they would in the period following October 31, 2001. As a result, we evaluate Research Question 2 by investigating those companies who announced early-adoption of the provisions of SFAS before and after the October 31, 2001 announcement of the SEC’s formal investigation of Enron.

Our sample was drawn from Internet press releases on the early adoption of SFAS 142 identified through an advanced search on Google for “goodwill early adoption.” Fourteen early adopters were identified in the first 100 “hits.” Our unorthodox sample technique reflects the unusual nature of the adoption window. The adoption window for SFAS 142 was still open at the time the sample was gathered. However, the September 11th terrorist attacks and the Enron collapse provided an unusual opportunity to look at certain aspects of early adoption. Accordingly, we decided to go ahead with this

exploratory sample in order to provide preliminary evidence on the early adoption of SFAS 142 in a timely manner.

Descriptive Statistics

Descriptive statistics for the fourteen companies in our sample appear in Table 1. The companies are drawn from a variety of industries including banking, healthcare and publishing. Three of the companies chose to early-adopt the provisions of SFAS 142 in the period before September 11, and eleven of the companies chose to early-adopt the provisions of SFAS in the period after September 11. Four of the companies chose to early-adopt the provisions of SFAS 142 in the period after September 11 and before announcement of the SEC's formal investigation of Enron on October 31, and seven of the companies chose to early-adopt SFAS 142 subsequent to October 31. Prior to early adoption of SFAS 142, none of the sample companies were experiencing losses, although results for five of the companies were less favorable than in the prior year.

Table 1 about here.

Companies for whom early adoption of SFAS 142 led to a decrease in earnings include those whose earnings were significantly below the year ago period and chose to take a "big bath," as well as companies whose earnings before the effects of the change were up significantly. In the case of the latter group, it is assumed that they decided it was an opportune time to make the change since the effects of the change would be negative and they had the earnings to absorb the charge at that time (i.e., income smoothing).

As previously mentioned, we also needed to consider the effect of the company's size on the early adoption decision. The impact of early adoption of this particular standard varied significantly from industry to industry, with the likely greatest impact on those industries with significant recorded goodwill. Consequently, size by itself is not the variable of interest here, but rather size within a given industry. Industry leaders might have the financial resources to more easily early adopt a new standard than others within a given industry. As none of the sample companies was a clear leader within its industry, size did not seem to be a factor in the early adoption decision for SFAS 142.

Findings

Research Question 1. Research Question (RQ) 1 is concerned with the association between levels of market acceptance of “bad news” and managers' propensity to early adopt the provisions of an accounting standard. To assess RQ 1, we examine differences in the companies who early adopt SFAS 142 in the pre- versus post-September 11th time periods.³ We find the three companies made the decision to early adopt in the pre-September 11th period and four companies made the decision to early adopt in the post-September 11th period. Further, three of the four companies that chose to early adopt in the post-September 11th time period reported positive income effects from such early adoption. This occurred during a period when the markets were presumably more disposed to accepting bad news. Accordingly, the data do not appear to provide support for RQ 1.

Research Question 2. RQ 2 is concerned with the association between levels of investor tolerance for earnings management and managers' propensity to early adopt the

³ Note that we limit the post-September 11th period to the period prior to the SEC's October 31 announcement of a formal investigation into Enron to minimize potential confounding effects associated with differences in investors' tolerance for earnings management in the pre/post-October 31 time periods.

provisions of an accounting standard. To assess RQ 2, we examine differences in the companies who early adopt SFAS 142 in the pre- versus post-October 31st time periods.⁴ A comparison of the pre- and post- October 31 time periods again reveals little change in behavior. While three-fourths of the companies in the pre-October 31 period increased earnings by early adopting, nearly 60% of the companies in the post-October 31 time period also increased reported earnings by the early adoption.

Discussion

Clearly, the results are not conclusive, both as a result of the sample size, and because the early adoption window for SFAS 142 was still open at the time the sample was drawn. However, they do not support a “piling on” with bad news in the period following the September 11th attacks, nor do they support a reigning in of boosting earnings through earnings management in the period subsequent to the Enron collapse. Instead, in both periods, it seemed to be business as usual in that the lion’s share of the early adopters did so to boost reported earnings.

An Evaluation of FASB’s Policy of Offering Extended Adoption Windows:

Discussion and Conclusion

Over the past several years, FASB has allowed multi-year adoption periods for many of its standards. However, by providing managers with multi-year adoption windows, FASB increases preparers’ ability to manage earnings (c.f., Gujarathi and Hoskin, 1992). Evidence in our exploratory study suggests that early adoption of standards to increase reported earnings persists, regardless of market expectations for bad news or investor intolerance for earnings management. This observed earnings

⁴ Note that we limit the pre-October 31st period to the period subsequent to the September 11th terrorist attacks to minimize potential confounding effects associated with differences in market expectations for “bad news” in the pre/post-September 11 time periods.

management behavior appears to be sufficiently strong as to be unaffected by clearly important exogenous events, in this case, the September 11th attacks and the Enron collapse. Consistent with Healy and Wahlen (1999), these findings suggest that because of the costs and benefits associated with the managerial judgment process inherent in financial reporting, “It is therefore critical for standard setters to understand when standards that permit managers to exercise judgment in reporting increase the value of accounting information to users and when the standards reduce it” (Healy and Wahlen, 1999: 369). Likewise, we believe it important for standard setters to consider when it appropriate to allow multi-period adoption windows. That is, perhaps one of the only ways to reign in artificial inflation of earnings through earnings management is to limit the tools with which companies can manage earnings – notably, by limiting the length of adoption windows and remove the opportunity for early adoption.

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Table 1
Sample of Companies Early Adopting SFAS 142

| Company | Announcement Date | GW Impairment Recorded* | Income Effect of Early Adoption |
|---|--------------------------|--------------------------------|--|
| <i>Pre-9/11 Period</i> | | | |
| Independent Commercial Bank | 1/24/01 | No | Increase |
| Airgas | 8/13/01 | Yes | Decrease |
| H&R Block | 8/15/01 | No | Increase |
| <i>Post-9/11 Period; Pre-10/31 Period</i> | | | |
| NCS Healthcare | 11/02/01 | No | Increase |
| Pervasive Software | 10/16/01 | Yes | Decrease |
| Readers' Digest | 10/31/01 | No | Increase |
| American Healthways | 10/04/01 | No | Increase |
| <i>Post-10/31 Period</i> | | | |
| Applied Industrial Technologies | 1/17/02 | Yes | Decrease |
| NUI | 1/15/02 | Yes | Decrease |
| Key Technology | 1/24/02 | No | Increase (Reduction of loss) |
| Isle of Capri Casinos | 1/27/02 | No | Increase |
| Celadon | 1/31/02 | No | Increase |
| Infogrames | 2/12/02 | Yes | Increase** |
| BHA Group | 2/22/02 | Yes | Decrease |

*Note all early adopters of SFAS 142 stopped amortizing goodwill. However, only some of the early adopters recorded impairments for goodwill.

**Note that only a portion of Infogrames' goodwill was impaired and so the increase to income resulting from discontinuing the amortization of goodwill exceeds the amount of the impaired goodwill that Infogrames wrote off.