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# American Accounting Association's Financial Accounting Standards Committee

Response to FASB Exposure Draft, "Accounting Changes and Error Corrections"

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#### Introduction

The Financial Accounting Standards Committee of the American Accounting Association ("the Committee") is charged with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the FASB Exposure Draft on Accounting Changes and Error Corrections (hereafter, the ED). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

This ED is a product of the Financial Accounting Standards Board's (FASB's) Short-term Convergence Project, the objective of which is to eliminate minor differences between U.S. GAAP and International Financial Reporting Standards (IFRS), which are issued by the International Accounting Standards Board (IASB) and include International Accounting Standards (IAS) issued prior to the IASB existence. The ED proposes to change the reporting for discretionary changes in accounting principle specified in APB Opinion No. 20, Accounting Changes (APB 20), and to standardize the transition reporting for mandatory adoption of new accounting principles. The ED was issued along with three other exposure drafts: Exchanges of Productive Assets—an amendment of APB Opinion No. 29, Earnings per Share—an amendment of FASB Statement No. 128, and Inventory Costs—an amendment of ARB No. 43, Chapter 41. The Committee supports the recommended changes proposed by these three exposure drafts and thus, does not provide any comments on them.

The Committee supports the goals of the Convergence Project. We agree with the FASB that it is important to minimize differences between the accounting pronouncements of the IASB and those of the FASB in order to simplify cross-border financial reporting. Nonetheless, we believe that it is important to maintain differences between U.S. GAAP and IFRS when convergence to a common set of financial reporting standards may result in less relevant and/or reliable financial statements or disclosures.

## The Exposure Draft

The ED requires the retrospective application and restatement of prior period financial statements for all changes in accounting principle, both discretionary and mandatory. The ED permits application of the prospective method when it is impracticable to

determine the cumulative effect of applying the change to all prior periods. The ED also states that transition guidance shall apply when explicitly provided in newly issued accounting pronouncements.

The ED mandates specific disclosures in the period of an accounting change. When the change is discretionary, the firm must clearly explain why the newly adopted accounting principle is preferable. In addition, when a change in accounting principle has an effect on the current period or any prior period presented, or may have an effect in subsequent periods, the firm must disclose (1) the effect of the change on each financial statement line item and any per share amounts affected for the current period and all prior periods presented, where financial statements of subsequent periods need not repeat the disclosures; (2) the amount of any adjustment relating to periods prior to those presented; (3) a statement that comparative information has been restated, or that restatement for a particular prior period has not been made because it is impracticable, together with the reasons for impracticability.

The effect of the ED is to move to the face of the income statement the footnote disclosures of pro forma amounts required under APB No. 20, and to eliminate the cumulative effect of the change in accounting principle reported as a separate line item on the current period's income statement. In addition, the ED requires a change in depreciation method to be accounted for prospectively as a change in accounting estimate and not as a change in accounting principle.

## Background on APB 20 and IAS 8

APB 20 was promulgated in 1971. It requires firms to report discretionary changes in accounting policy by including the cumulative effect of the change in accounting principle in income of the period that the change is made. Transition reporting for mandated changes in accounting policy has heretofore been prescribed in each new standard as it is adopted, and guidance has varied. In the APB 20 Basis for Conclusions, the Accounting Principles Board acknowledged the trade-offs in accounting for a change in accounting principle as either a cumulative effect in current period income or by restating prior periods' financial statements. APB 20 represents a compromise position requiring firms to report the cumulative effect of a change in accounting principle as a separate line item on the income statement, and simultaneously requiring foomote disclosure of pro forma income assuming the newly adopted accounting principle had been used in prior periods. The cumulative effect arguably highlights the inconsistent application of accounting methods while the required footnote disclosure of the retroactive restatement provides the user with financial variables measured under a consistent application of an accounting method.

IAS 8, Unusual and Prior Period Items and Changes in Accounting Policies, first issued in 1977 and revised in 1993, stated that a change in accounting policy should be made only if required by statute, or by an accounting standard setting body, or if the change would result in a more appropriate presentation of events or transactions of the enterprise. The 1993 version of IAS 8 allowed a change in accounting policy to be

applied retrospectively or prospectively. Because of the criticisms and concerns related to the discretion available under IAS 8, the IASB included IAS 8 in its project on Improvements to International Accounting Standards. The current version of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (issued in December 2003) now states that an entity can change an accounting policy only if the change is required by IASB standards or interpretations or results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance, or cash flows. IAS 8 requires retrospective application with restatement of prior period results for all changes in accounting policies. In addition, IAS 8 explicitly identifies changes in the amount of the periodic consumption of an asset, i.e., a change in depreciation method, as a change in accounting estimate because such changes occur because of new information or new developments. IAS 8 prescribes prospective treatment for a change in accounting estimate.

## Reasons for issuing the ED

Since the mid-1990s the FASB has supported the international convergence of financial reporting standards. One of the FASB's objectives is to increase the international comparability and the quality of standards used in the United States. Its promotion of international accounting standards convergence is consistent with this objective. In October 2002, the FASB formalized its commitment to participate in the development of high-quality international accounting standards by issuing a Memorandum of Understanding with the IASB. The Memorandum of Understanding (named the Norwalk Agreement) articulates the intent of the FASB and IASB to make their existing standards fully comparable as soon as practicable and to coordinate their future work programs to ensure continued comparability. As part of the Norwalk Agreement, the FASB and the IASB agreed to undertake a short-term project aimed at removing differences between U.S. GAAP and IFRS.

The specific objective of the Short-term Convergence Project is to remove perceived minor differences between U.S. GAAP and IFRS that are not within the scope of other major projects by either (1) amending applicable U.S. GAAP literature to reduce (eliminate) the difference or (2) communicate to the IASB the Board's rationale for electing not to change U.S. GAAP. The ED is part of the Short-term Convergence Project. The ED states that the FASB would improve financial reporting by converging with IAS 8.

#### Relevant research

Management can make changes in accounting principles in response to the FASB's promulgation of new accounting standards (mandatory changes) or to various other stimuli (discretionary changes). To date professional standards have required different treatments for these changes: retrospective application with a restatement of prior period results, retrospective application with a cumulative adjustment of prior period results reported in current income, and prospective application with no adjustment of prior

period results. In some circumstances the standard setters have required disclosure in the footnotes of the pro forma effect of the change on prior periods. In this section, we discuss research that addresses issues related to disclosures about accounting changes, recognition versus disclosure, and voluntary disclosure.

Research addressing accounting policy changes focuses on the consequences of recognition versus disclosure. Brown (1983) documents that analyst forecast errors in periods of accounting changes vary depending on how the accounting change is reported. He found that analysts' earnings forecasts became more accurate upon the introduction of SFAS 13 (lease accounting), which required pro forma disclosures of the effect on prior periods, while forecasts did not improve upon the introduction of SFAS 34 (interest capitalization), which had no such requirement. Assuming both standards address relevant economic events, that study implies that users benefit from expanded disclosures about the effect of mandated accounting changes.

Other research on the issue of recognition versus disclosure includes the work of Imhoff, Lipe and Wright (1995) with respect to lease accounting, Aboody (1996) with respect to oil and gas accounting, and Davis-Friday et al. (1999) with respect to other post-employment benefits. That work provides evidence that recognized accounting variables have greater associations with security prices than do accounting variables disclosed in the footnotes. Esphabodi et al. (2002) provide evidence that market prices are sensitive to the expectation of whether stock-based compensation will be recognized or simply disclosed. Hirst and Hopkins (1998), and Hirst, et al. (2004) find that professional security analysts' valuation judgments are influenced by where financial information is disclosed in the financial statements. Information disclosed in performance statements is generally more influential than the same information disclosed elsewhere. In their experimental setting, they are able to rule out the alternative explanation that the results are due to differential perceived reliability of recognized versus disclosed data. On balance, this work calls into question the equivalence of retrospective application of prior period results and footnote disclosure of the pro forma effect of accounting changes.

Discretionary changes in accounting principles may be made in response to changing economic facts and circumstances or to achieve desired reporting objectives. Fields et al. (2001) survey the empirical literature on the broad area of accounting choice, a subset of which includes discretionary changes in accounting principle. They cite several studies that suggest that managers sometimes choose accounting methods opportunistically. More specific to managers' accounting policies, prior empirical literature focusing on the time series of firms' accounting policies. Erickson and Wang (1999) argue that managers choose accounting policies. Erickson and Wang (1999) argue that managers choose accounting policies with the objective of increasing the stock price of the acquiring firm in anticipation of stock for stock mergers. Sweeney (1994) finds evidence that firms make income increasing accounting changes to avoid default. Johnston and Ramanan (1988) report evidence consistent with the hypothesis that firms elect to adopt full-cost accounting for oil and gas activities in order to reduce the probability of violating debt covenants. In contrast, Healy and Palepu (1990) and DeAngelo, DeAngelo and Skinner (1994) find no evidence that firms make accounting

policy changes in response to dividend constraints. Lilien, Martin, and Pastena (1988) find evidence that unsuccessful firms are more likely to make income increasing accounting changes than are successful firms. Schwartz (1982) concludes that managers make accounting changes to improve their financial appearance. Moses (1987) reports that firms make discretionary accounting changes to smooth earnings. Elliott and Philbrick (1990) find that analyst forecast errors are larger in the year of an accounting change and larger still in the absence of prior disclosure (outside of the financial statements) of information about the change. They also report findings consistent with managers adopting accounting changes with an income smoothing motivation.

In their survey of the empirical literature on accounting choice, Fields et al. (2001) conclude that there is no compelling evidence that the market is able to see through opportunistic managers' accounting choices. Daniel et al. (2002) review the literature that addresses investor psychology in the capital markets and conclude that investors do not adequately discount managers' incentives to manipulate an information event or signal. Their discussion suggests that investors are insufficiently skeptical of managers' accounting choices due to limited processing power or to overconfidence. Further evidence on whether markets see through potentially opportunistic disclosures is presented in Doyle et al. (2003). They find that non-GAAP measures of "pro forma" earnings containing contain higher levels of exclusions from GAAP earnings lead to reliably lower levels of future cash flows. They also find that investors do not appreciate this relation at the time of earnings announcements.

In contrast to studies suggesting markets react naïvely to opportunistic behavior of managers, there is a large body of literature on voluntary disclosure (for a review see Healy and Palepu 2001) challenging this view. Some empirical work suggests that managers' voluntary disclosures are value relevant, and that the market reacts in a reasonably sophisticated manner to these management disclosures. Hutton et al. (2003) and Baginski et al. (2004) argue that investors distinguish between more and less credible management disclosures that accompany management earnings forecasts. Beatty, et al. (2002) provide evidence suggesting that debt markets anticipate the effect of management's voluntary accounting changes on contracts, and adjust the terms of the contracts accordingly.

The relevant empirical literature suggests that retrospective application of changes in accounting principle, with restatement of prior period results or pro forma disclosures in the footnotes, improves analyst forecast accuracy. Relevant research also suggests that recognition of accounting variables is superior to disclosure in terms of generating price reactions. If all accounting changes are made in response to changes in the underlying economics of the firm, we conclude that the literature supports retrospective application of the accounting change, combined with restatement of prior period results. However, if some discretionary accounting changes are opportunistic (and extant evidence suggests this is the case), research provides no direct evidence to guide the selection of retrospective or prospective reporting for discretionary accounting changes. A preference for retrospective or prospective accounting is determined by how one or the other masks the impact on financial trends. Clear disclosure of the impact of the discretionary change

on current and past financial performance and position along with reasons for the change will afford users the opportunity to gauge for themselves whether initially reported or adjusted data are most relevant.

## Comments on the ED

Our comments on the ED distinguish between *mandated* changes in accounting principle, triggered by the FASB's promulgation of a new accounting standard, and *discretionary* changes in accounting principle, triggered by management's decision to apply a different accounting principle from the one currently being used.

### Mandatory Changes

We support the ED's establishment of retrospective application as the standard transition method for mandatory adoption of a new accounting standard. The objective of promulgating a new standard is to improve financial reporting and as such, the retrospective application results in more consistent and comparable financial information. In addition, the standardization of accounting principle transitions is important in that it produces consistency in the implementation of pronouncements. We expect this consistency to reduce the implicit costs incurred by users, who will no longer have to deal with variation in how firms implement new standards.

Preparers of financial statements, however, may face additional costs. The costs include not only those of generating year-by-year comparative data, but also potential audit costs associated with finer disclosures. We are not in a position to estimate the magnitude of those costs. We note that paragraph 2b of the ED defines accounting pronouncements broadly to specifically include FASB Interpretations, FASB Staff Positions, EITF Consensuses, and beyond. We encourage the Board to consider the potential costs to preparers as well as the effect on users' confidence in financial reporting in determining the transition guidance for future pronouncements. A continuous stream of retrospective adjustments might well overwhelm the ability of investors to process the information.

#### Discretionary Changes

The Committee is split on whether retrospective application should be *required* for discretionary changes in accounting principles. The viewpoints differ on whether retrospective application or prospective application provides more information to investors.

The Board suggests that restating the financial statements as if a newly adopted accounting principle had always been used results in greater consistency across reporting periods. One part of the Committee questions this view. If we assume an accounting principle was originally adopted because at the time it best reflected the underlying economic position of the firm, then we interpret the change to an alternative method as evidence that firm economics have changed. In these circumstances, we argue that

consistency across periods is neither necessary nor desirable. In this situation, the change in accounting principle is inseparable from a change in accounting estimate.

In contrast, if the discretionary accounting change is not a response to changing economics, but rather is an instance of managerial opportunism, we question whether retrospective application will mask managers' discretionary reporting practices. For example, managers may make choices that appear conservative on the surface but allow revenues to be reported twice or to have declining trends reverse under the new method. Nonetheless, it is not clear that prospective application with cumulative adjustments solves this dilemma.

Pragmatically, a standard cannot be written to treat honest and opportunistic choices differently. If consistency is of sufficient importance, then retrospective application with sufficient footnote disclosure of the impact of the change on past and current reported financial statements will allow users to come to their own conclusions about the veracity of the data. We note that the ED specifically states that financial statements of subsequent periods need not repeat the disclosures related to the contemporaneous discretionary change in accounting policy. Unless a user is aware of and takes action to obtain prior years' financial reports, retrospective application potentially results in incomplete financial reporting. We recommend that disclosure of the effect of an accounting change continue to be reported in the notes to the financial statements until statements that originally used the old method are no longer included as comparative statements (normally a two year period).

We do support the Board's requirement that the firm supplementally disclose the nature of and justification for a discretionary change in accounting principle and its effect on income in the financial statements of the period of the change.

Finally, we support the Board's position that a change in depreciation method should be accounted for as a change in estimate.

Thank you for the opportunity to provide our views on this exposure draft.

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