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COMMENTARY

Response to FASB Exposure Draft: Accounting Changes and Error Corrections

AAA Financial Accounting Standards Committee

INTRODUCTION

In December 2003, the Financial Accounting Standards Board (FASB) issued an Exposure Draft, *Accounting Changes and Error Corrections—a Replacement of APB Opinion No. 20 and FASB Statement No. 3* (the ED), as part of its short-term convergence project with the International Accounting Standards Board (IASB). The Financial Accounting Standards Committee of the American Accounting Association (the Committee) submitted a comment letter on the ED to the FASB in April 2004. This article summarizes the Committee's letter. Comments in this article reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The objective of the FASB's Short-Term Convergence Project is to eliminate minor differences between U.S. GAAP and International Financial Reporting Standards (IFRS), which are issued by the IASB and include International Accounting Standards (IAS) issued prior to the IASB's existence. The ED proposes to change the reporting for discretionary changes in accounting principle specified in APB Opinion No. 20, *Accounting Changes* (APB No. 20), and to standardize the transition reporting for mandatory adoption of new accounting principles. It 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 4*. The Committee supports the recommended changes proposed by these three exposure drafts but did not provide any comments on them.

The Committee supports the goals of the Convergence Project. We agree that it is important to minimize differences between the accounting pronouncements of the IASB and 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 reduces either the relevance or reliability of financial statements or disclosures without compensatory improvements on the other dimension.

THE EXPOSURE DRAFT

To date, professional standards have required different treatments for accounting changes: retrospective application through equity with a restatement of prior period results (hereafter referred

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to as the restatement method), retrospective application through income with a cumulative adjustment of prior period results reported in current income (hereafter referred to as the cumulative effect method), and prospective application with no adjustment of prior period results (hereafter referred to as the prospective method). In addition, in some circumstances, standards have required disclosure in the footnotes of the pro forma effect of the change on prior periods. The ED requires the restatement method 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 will supersede the ED's guidance when explicitly provided in newly issued accounting pronouncements.

The ED also 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 require retroactive restatement of the main financial statements and to eliminate the cumulative effect method of reporting a change in accounting principle. In addition, the ED requires that a change in depreciation method be accounted for prospectively as a change in accounting estimate and not as a change in accounting principle.

Background on APB No. 20 and IAS No. 8

APB No. 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 when 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 No. 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 No. 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 footnote disclosure of pro forma income assuming the newly adopted accounting principle had been used in prior periods. The cumulative effect method 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 No. 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, 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 No. 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 No. 8, the IASB included IAS No. 8 in its project on Improvements to International Accounting Standards. The current version of IAS No. 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 No. 8 requires the restatement method for all changes in accounting policies. In addition, IAS No. 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 No. 8 prescribes the prospective method 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) communicating 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 No. 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). In this section, we discuss research that addresses issues related to disclosures about accounting policy changes, recognition versus disclosure, and voluntary 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 No. 13 (lease accounting), which required pro forma disclosures of the effect on prior periods, while forecasts did not improve upon the introduction of SFAS No. 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.

Research on the issue of recognition versus disclosure includes the work of Imhoff et al. (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 the location of financial information in the financial statements. Information disclosed in the body of the financial 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 their results are due to differential perceived reliability of recognized versus disclosed data. On balance, this work calls into question the equivalence of the restatement method versus the cumulative effect method with 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 policy choices, prior empirical literature focusing on the time series of firms' accounting policies provides evidence that managers may make opportunistic changes in 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 et al. (1994) find no evidence that firms make accounting policy changes in response to dividend constraints. Lilien et al. (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 on investor psychology in the capital markets and conclude that investors do not consider managers' incentives when they interpret reported financial information. 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 "pro forma" earnings with higher levels of excluded expenses are associated with lower 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 do not completely see through the 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 literature reviewed suggests that the restatement method improves analyst forecast accuracy. Furthermore, it suggests that recognized accounting data are more closely associated with security prices than are disclosed data. If, however, some discretionary accounting changes are opportunistic (and extant evidence suggests this is the case), research provides no direct evidence to guide the selection of an accounting method for reporting these changes. A preference for the restatement or prospective method 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 EXPOSURE DRAFT

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 the restatement method 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 restatement method 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 restatements due to changes in accounting standards might well overwhelm the ability of investors to process the information. The Committee notes that consistency is a desired attribute of financial reporting, and this consistency is sacrificed with each new pronouncement.

Discretionary Changes

The Committee is split on whether the restatement method should be required for discretionary changes in accounting principles. The viewpoints differ on whether the restatement method or prospective method 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. Some Committee members question this view. If discretionary accounting changes are not made opportunistically, then one can assume that original adoption of an accounting principle implies that that principle best reflected the underlying economics of the firm at that time. From this perspective, the change to an alternative method is evidence that the firm's economics have changed. In these circumstances, consistency across periods is neither necessary nor desirable. That is, the change in accounting principle is inseparable from a change in accounting estimate, and the prospective method is the preferred method.

Under the alternative assumption that managers act opportunistically, one can interpret a discretionary accounting change as an attempt to manipulate reported results. From this perspective, the restatement method may mask managers' opportunistic reporting practices. Because the ED does not require financial statements of subsequent periods to repeat the disclosures about the effect of the change, managers may be able to create the impression of improving performance. In addition, performance metrics used in decision making may be biased under the restatement method because the cumulative adjustment flows directly to opening equity (rather than through the income statement or comprehensive income). For example, if a manager's compensation is a function of reported net income, cumulative compensation under the restatement method would not reflect the cumulative effect of the accounting change.

Pragmatically, a standard cannot be written to treat economic and opportunistic accounting changes differently. The restatement method with sufficient footnote disclosure of the impact of the change on past and current reported financial statements will allow users to draw their own conclusions about the integrity of the trends and the data. Because the ED does not require financial statements of subsequent periods to repeat the disclosures related to the discretionary change in accounting policy, the restatement method potentially results in incomplete financial reporting unless a user is aware of and takes action to obtain prior years' financial reports. Therefore, 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). Finally, we support the Board's position that a change in depreciation method should be treated as a change in estimate and thus be accounted for under the prospective method.

CONCLUSION

The promulgation of a new standard on accounting changes is important given the dynamic accounting standard-setting environment and the frequency with which firms voluntarily change their accounting methods and estimates. The Committee agrees that the ED will likely result in more comparable financial information across firms internationally because the treatment of changes in accounting methods and estimates will be the same under U.S. GAAP and IFRS. Whether the ED results in a firm reporting more consistent financial information is conditional on whether the accounting change is discretionary and if discretionary, whether the accounting change reflects changes in the firm's economic environment. Because of the inability of financial statement users to distinguish between a discretionary change driven by a change in a firm's economic environment versus a discretionary change due to opportunistic reporting, we argue that firms be required to disclose in the footnotes the effect of a discretionary accounting change for as long as the change affects the comparative statements.

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