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Further evidence of earnings management and opportunistic behavior with principles-based accounting standards: The case of conditional asset retirement obligations

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ABSTRACT

FASB Interpretation No. 47 (FIN 47) clarifies the diverse accounting practices for conditional asset retirement obligations (CAROs) that arose under SFAS No. 143, which is classified as a principles-based standard by the SEC. Prior research suggests that the subjectivity in SFAS No. 143 provides management with the opportunity to manage earnings and avoid the recognition of CAROs. This study examines firms that recorded adjustments for CAROs upon FIN 47 adoption. We demonstrate that effective monitoring is essential to promote adherence with principles-based standards, and that gatekeepers may not be effective when standards are ambiguous. Univariate tests and logistic regressions reveal that FIN 47 adopters have audit committees with a greater number of financial experts and are audited by BIG 4 firms. Particular firm-specific factors are also found to be associated with the adoption decision. The results also indicate that newly-reported obligations related to asbestos in firm-owned property and restoration costs for leased premises were subject to prior management discretion. This study extends existing literature on SFAS No. 143 and FIN 47 and studies examining earnings management with principles-based standards. The case of FIN 47 provides further evidence that significant opportunities for earnings management and discretion exist within a principles-based accounting environment, particularly when standards lack clarity. It also confirms the critical role of monitoring by the audit committee and external auditors to promote adherence with the substance of such standards.

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1. Introduction

SFAS No. 143, *Accounting for Asset Retirement Obligations*, establishes standards related to the measurement and recognition of asset retirement obligations (AROs) and requires firms to recognize the fair value of such liabilities in the period incurred. The accounting for AROs requires a high degree of judgment by management and external auditors because these obligations often pertain to activities that will occur several decades in the future. After SFAS No. 143 became effective in 2003, the FASB detected that many entities were not properly accounting for "conditional" AROs (i.e., CAROs), which result when the timing and/or method of settling the obligation is dependent on a future event that may not necessarily be controllable by the entity. In response, the FASB issued Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, *an interpretation of FASB Statement No. 143*, which became effective as of December 31, 2005 for calendar year companies.

The objective of FIN 47 is to "clarify" and reiterate several aspects about the accounting for CAROs already set forth in SFAS No. 143. At the time, the FASB considered FIN 47 as an "education effort" (FASB, 2004b) and expected that adding clarity to the existing accounting guidance would assist senior management (and their auditors) implement the provisions of SFAS No. 143 as originally intended. The issuance of FIN 47 was deemed particularly important by the FASB given evidence of an unanticipated degree of subjectivity and discretion in the scope, measurement and recognition provisions of SFAS No. 143 as to CAROs. This discretion provided management with opportunities to avoid the recognition of existing obligations and associated income-decreasing accruals. The transparency provided by FIN 47 resulted in the recognition of unrecorded CAROs and cumulative-effect adjustments to income upon adoption.

In prior research on the accounting for AROs, Jordan et al. (2007) posit that SFAS No. 143 provides management with the opportunity to manage earnings given the inherent subjectivity in determining the fair value of the obligations and the discount rates used to recognize annual accretion expense on the amount of the liability. Ely and Stanny (2007) examine a sample of firms that adopted FIN 47 and find that highly-levered firms were less likely to have complied with the principles in SFAS No. 143. They conclude that this provides evidence of earnings management in an attempt to avoid the violation of loan covenants.

The debate and dialogue over the benefits and consequences of principles-based versus rules-based accounting standards has ensued for some time, particularly since the accounting scandals that prompted passage of The Sarbanes Oxley Act (SOX) and the increasing complexity of financial reporting in general. In a study pursuant to SOX, the SEC (2003a) expressed its preference for principles-based over rules-based standards. In general, principles-based standards are characterized by a concise statement of the accounting objective, few if any scope exceptions, an "appropriate" amount of implementation guidance, lack of bright-line tests, and consistency with a coherent conceptual framework (SEC, 2003a; FASB, 2004c). Principles-based standards also impose a greater responsibility on management and the auditors to report the underlying economic substance of transactions. Accordingly, effective gatekeepers such as vigilant audit committees and independent external auditors, whose roles were strengthened under SOX, are necessary to ensure that accounting standards are interpreted and applied in accordance with the substance and intent of the underlying principles (SEC, 2003a). Unfortunately, as demonstrated in this study, the effectiveness of gatekeepers can be significantly diminished when principles-based standards are ambiguous. In the SEC study, SFAS No. 143 was specifically classified as a principles-based standard (SEC, 2003a).

Despite the expectations by many that principles-based standards will improve financial reporting compared to a rules-based system, Jamal et al. (2010, p. 143) contend that there is "virtually no empirical evidence available to support these beliefs." They caution that standards-setters have already reduced their emphasis on verifiability as a key quality during the development of standards. Coupled with the shift toward the inherent subjectivity of fair value measurements, this "significantly impairs the ability… to limit opportunistic actions by management" and the auditor's ability to detect them. In fact, several studies, (e.g., Nelson et al., 2002; Nelson, 2003; Van Beest, 2009, etc.) find that significant opportunities for earnings management exist in a principles-based accounting environment.

Given this background, we examine the consequences of the ambiguity in SFAS No. 143 and the subsequent issuance of FIN 47 which provided clarifying language to promote compliance with the