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journal homepage: www.elsevier.com/locate/aosReporting accounting changes and their multi-period effects[☆]Scott A. Emmett^{a,*}, Mark W. Nelson^b^a W.P. Carey School of Business, Arizona State University, Tempe, AZ 85287, United States^b Johnson Graduate School of Management, Cornell College of Business, Sage Hall, Ithaca, NY 14853, United States

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ABSTRACT

U.S. GAAP and IFRS require full disclosure of the effects of an accounting change in the year the change is made, but not in future years. However, some accounting changes have multi-period effects. We conduct an experiment to examine whether investors forget to adjust for an accounting change in periods subsequent to the change, and examine the effectiveness of interventions designed to mitigate that tendency. In the experiment, a company changed how it accounts for pension gains and losses, and investors value the company over three consecutive reporting periods. Results indicate that investors gradually forget to adjust for the accounting change over time under the current approach used to disclose accounting changes. These effects are mitigated in post-change periods when investors receive full disclosure of the current effect of the prior accounting change, and to a lesser extent when investors receive a disclosure that includes a simple non-quantitative disclosure that the accounting change occurred. Supplemental analyses indicate that investors rely more on memory-aiding disclosures as the time delay between valuation judgments increases.

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1. Introduction

Financial accounting standards require firms to clearly and prominently disclose how an accounting change affects the financial statements in the year firms adopt the change (FASB ASC paragraph 250-10-50-1; IAS 8.29). However, firms are *not* required to disclose this information in years subsequent to a change, even if the accounting change materially impacts financial statements over multiple years. We investigate whether lack of subsequent-year disclosure of accounting changes causes investors

to increasingly forget to adjust for the effects of the accounting change over time, leaving them vulnerable to inconsistent accounting over time and to non-comparable accounting between firms. We also investigate whether two different types of multi-period disclosure of accounting changes mitigate this tendency.

Prior research suggests that investors might respond to concerns about such accounting by backing out the effects of the accounting from earnings and other financial-statement line items (e.g., see Hopkins, Houston, & Peters, 2000) and/or discounting future earnings to a greater extent because of concerns about the firm and its management (e.g., see Barton & Mercer, 2005). Yet, prior research has not investigated how investors react to accounting changes over time, or to alternative post-change disclosures designed to help investors consider the lasting effects of those changes.

We examine two complementary research questions. First, we investigate whether investors increasingly ignore the effects of an accounting change over time in the absence of multi-period disclosure about the accounting change. We focus specifically on whether limitations in investors' long-term memory contribute to this effect. We expect that investors who initially learn of an accounting change store that information in long-term memory but gradually forget about the change over time and increasingly fail to adjust valuation judgments in subsequent periods.

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Second, we investigate whether multi-period disclosure about accounting changes can help investors adjust for accounting changes over time. We focus on two types of disclosure of the subsequent-year effects of accounting changes: (1) a reconciliation of results under the new and old accounting method, and (2) a non-quantitative disclosure that the change occurred. Because the reconciliation disclosure and non-quantitative disclosure both counteract limitations in investors' long-term memory, we expect that they both aid memory to some extent. However, we expect that a reconciliation disclosure is more effective than a non-quantitative disclosure, because a reconciliation disclosure is more salient and also reduces the cognitive processing costs associated with estimating the impact of the change in post-change periods.

We address our questions within a pension accounting setting. U.S. GAAP allows firms to recognize some pension gains and losses in other comprehensive income (OCI) and to amortize these costs into net income over time (hereafter, the "smoothing approach") (FASB ASC paragraph 715-30-35-4). However, firms can choose an alternative policy of recognizing these amounts in net income in the year in which they are incurred (hereafter, the "fair value approach") (FASB ASC paragraph 715-30-35-25), resulting in financial statements that are not comparable between firms that use the smoothing and fair-value approaches. Recently, several large U.S. firms (e.g., AT&T, Honeywell, IBM, UPS, Verizon, and Kellogg) have changed to the fair value approach (e.g., see Rapoport, 2014).¹ Given recent macro-economic conditions (which we operationalize in our experiment), switching to the fair value approach produces higher future earnings.² While the pension setting is important in its own right, it also allows us to shed light on the potential impact of other accounting changes that create large differences in reported net income but obscure those differences by scattering them across accounts and over several reporting periods.³

To test our predictions, we conduct a 3×5 mixed-design experiment. MBA and undergraduate students with prior coursework in finance and accounting (including pension accounting) take the role of a prospective investor and view financial statement excerpts and industry information about a fictional firm in the information technology hardware industry.

We manipulate the passage of time by providing participants with financial reports from three successive reporting years for the firm. Participants wait at least 18 h between each year to operationalize the time lags inherent between reporting years. For each of these reporting years, investors receive various excerpts from financial reports and estimate the stock price of the firm.

We manipulate the presence and nature of multi-period

disclosure about the accounting change between subjects at five levels, holding constant the underlying economic performance of the firm and its pension plan. In two baseline conditions, the reporting firm either does not make an accounting change or does make the change but never provides any disclosure that the accounting change occurred. In the other three conditions, the reporting firm makes the change and follows current GAAP by providing a footnote in the period of change that discloses the change and reconciles income under the old and new accounting approaches. However, these three conditions differ in the disclosures provided in post-change periods. In one condition, the firm does not provide multi-period disclosure about the accounting change; in another condition, the firm provides a reconciliation disclosure; and in the final condition, the firm provides a non-quantitative disclosure that the change occurred.

Results indicate that, as anticipated, investors who did not receive multi-period disclosure about the accounting change exhibit systematic forgetting, making valuation judgments that converge over time with the valuation judgments of investors who never received disclosure of the change. This effect is mitigated to some extent in the two alternative disclosure conditions, with the multi-period reconciliation disclosures more effective than the multi-period non-quantitative disclosures.

Supplemental analyses provide further insight. Because participation in each reporting period occurred over approximately 24-h windows, we can conduct more stringent tests of the role of memory by comparing judgments of investors who experienced longer delays after initially learning of the accounting change. Results indicate that investors exhibit some forgetting regardless of whether they had longer or shorter delays, but that investors high in time delay benefit more from availability of a reconciliation or non-quantitative disclosure. Thus, high time delay appears to increase the benefit of memory-aiding disclosures. For high time-delay investors, the non-quantitative disclosure is as effective as the full reconciliation, suggesting that multi-period disclosures about the accounting change provide benefits primarily by aiding memory rather than by reducing the cognitive processing costs associated with estimating what earnings would have been absent the accounting change.

Our study extends prior research in several ways. First, we examine how investors react to accounting changes over time. Our study complements prior research (Hopkins et al., 2000; Krische, 2005) by manipulating the occurrence and disclosure of accounting changes longitudinally, providing opportunities for investors to process the change and encode it in long-term memory when it occurs as well as opportunities to forget about the change over time. Our longitudinal approach overcomes some of the limitations that are often voiced about one-shot financial reporting studies (e.g., see Lipe, 1998, p. 82) and allows us to examine the influence of causal mechanisms that would be difficult to observe in one-shot settings. We hope this first step in operationalizing multi-period disclosure settings leads to further experimental research that builds upon our study.

More broadly, our study contributes to the literature on disclosure presentation. Much of the research on disclosure presentation focuses on how various presentation attributes affect the ease with which investors process information in disclosures (see Libby & Emmett, 2014 for a review), because processing difficulty is hypothesized to affect the extent to which information is impounded into market prices (Bloomfield, 2002). We contribute to this literature by examining how two specific accounting institutions (the passage of time between reporting periods and alternative methods of disclosing accounting changes) combine with a specific psychological mechanism (memory limitations) to affect the ease with which investors incorporate accounting changes into their

¹ Critics argue that these firms made accounting changes to increase earnings and stock valuations (e.g., see Burr, 2011; Cheng, 2011; Rapoport, 2011; Thomson, 2011). For example, Burr (2011) argues that firms making the change are trying to "dodge reporting large past losses in current and future financial statements, [preventing the losses from] being a drag on corporate income."

² As discussed further in section III, we operationalized plausible macroeconomic conditions similar to those experienced recently and that will likely be experienced in the future, with firms having accumulated large pension losses but enjoying current-period pension gains due to increasing interest rates and an increasing stock market.

³ For example, selecting the fair value option to account for available-for-sale investments also involves a choice to recognize fair values immediately rather than have delayed recognition via recycling through OCI. Other contexts that have multi-period effects include designating a financial instrument as a fair-value or a cash-flow hedge, choosing a functional currency for currency translation, choosing FIFO/LIFO treatment of inventory, choosing depreciation methods, and disclosing restructuring charges. We believe our setting generalizes to real-world contexts in which variation in accounting for these types of transactions exists and/or convergence within industries to a single approach has not yet completed.

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