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Timely loss recognition and termination of unprofitable projects

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ABSTRACT

Ideally, firms should discontinue projects that become unprofitable. Managers, however, continue to operate such projects because of their limited employment horizons and empire-building motivations (Jensen, 1986; Ball, 2001). Prior studies suggest that timely loss recognition in accounting earnings enables lenders, shareholders, and boards of directors to identify unprofitable projects; thereby, enabling them to force managers to discontinue such projects before large value erosion occurs. However, this conjecture has not been tested empirically. Consistent with this notion, we find that timely loss recognition increases the likelihood of timely closures of unprofitable projects. Moreover, managers, by announcing late discontinuations of such projects, reveal their inability to select good projects and/or to contain losses, when projects turn unprofitable. Accordingly, thereafter, the fund providers and board of directors are likely to demand improved timeliness of loss recognition and stringent scrutiny of firms' capital expenditure plans. Consistently, we find that firms that announce large discontinuation losses reduce capital expenditures and improve timeliness of loss recognition in subsequent years. Our study provides evidence that timely loss reporting affects "real" economic decisions and creates economic benefits.

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1. Introduction

It is inevitable that some capital expenditure projects that firms undertake would later turn out to be unprofitable.[3] Investors would prefer that managers terminate such projects once their losses become apparent. However, managers may inefficiently continue to operate unprofitable projects, thereby magnifying firms' economic losses, rather than terminating them in a timely manner (e.g., Ball, 2001). This behavior stems from managers' limited employment horizons, empire building tendencies, overconfidence, aversion to reporting losses, and the fear of loss of reputation, remuneration, and employment. Prior studies suggest that timely loss recognition in accounting earnings should enable lenders, shareholders, and boards of directors (hereafter referred to as the "principals") to identify unprofitable projects in a timely manner, thus, enabling them to force managers to discontinue such projects before large value erosion (e.g., Ball, 2001; Ball and Shivakumar, 2005; Watts, 2003; LaFond and Roychowdhury, 2008). In this study, we examine whether timely reporting of losses results in timely termination of unprofitable projects, a question that remains unexamined.

In a related study, Ahmed and Duellman (2007, 2011) examine determinants of firms' project selection. They examine whether firms that recognize losses in a timely manner make good investment decisions. Similarly, Francis and Martin (2010) examine whether timely loss recognizers undertake profitable, and hence longer-lived, acquisitions. In addition, they examine whether timely loss recognizers divest acquired companies in a timely manner. Neither study examines companies' ex-post termination of unprofitable projects, however.[4] Firms are likely to initiate and terminate projects more frequently than they acquire and sell other companies. Thus we focus on the decision to discontinue operations since these are likely to represent a more complete picture of managers' investment decisions that turn unprofitable. Discontinued operations reported in the financial statements are important by definition since they are material. Decisions related to such projects create significant agency conflicts because their continuation, on the one hand, increases losses for lenders and shareholders, but on the other hand, may benefit managers. Accordingly, our study examines whether timely loss recognition reduces agency conflicts in the decision to discontinue operations.

We assume that managers are averse to discontinuing any projects, and therefore only terminate unprofitable projects.[5] We conjecture that firms with timely loss recognition are more likely to terminate unprofitable projects. Therefore, we first examine whether project discontinuations are positively associated with timely reporting of losses in the three-year period preceding the discontinuations. Consistent with prior studies (e.g. Francis and Martin, 2010), we use a matched-pair design. We identify a control group of firms that have similar investment opportunities and face similar economic shocks (that make projects unprofitable) as the sample discontinuation firms. The control group firms do not announce termination of unprofitable projects in the sample firm's discontinuation year or in the preceding three years. Accordingly, we examine whether sample firms that announce termination of projects have more effective timely loss recognition in the three preceding years than the control group.

We need a firm-year specific measure of timeliness of loss recognition to examine our research questions. We do not use measures that require multiple years' data for calculation (for example, Basu (1997) and Ball and Shivakumar (2005) measures) because we assume that firm characteristics can change over time. Accordingly, we use two state-of-the art measures of the timeliness of loss recognition at the firm-year level. Following Francis and Martin (2010), we use CSCORE (Khan and Watts, 2009).[6] We also report results for

[3] In this study, the notion of project "unprofitability" includes instances of (1) current losses; (2) negative present value of future cash flows; or (3) liquidation value exceeding present value of future cash flows. Such instances reduce firm value.

[4] Tan (2013) examines actions lenders initiate after debt covenant violation, resulting in more conservative investment decisions and financial reporting. Biddle et al. (2013) examine changes in financial reporting following increased bankruptcy risk.

[5] Bunsis (1997) and Jaggi et al. (2009) find evidence that shareholders react positively to asset write-downs that involve closing of an unprofitable plant or division.

[6] CSCORE is derived from Basu's (1997) notion of asymmetric timeliness of loss recognition and is a firm-year specific measure of conditional conservatism. Firm-year values of CSCORE can be calculated from cross-sectional returns and earnings data for one year. Similar to Basu's measure, CSCORE is calculated from earnings-return coefficients for firms with positive or negative returns. For our tests, we use the negative-return coefficient (rather than the difference between the coefficients for negative and positive returns) because we are interested in measuring cross-sectional variation in the timeliness of loss recognition. Khan and Watts (2009) label this measure "bad news timeliness" and obtain it by summing CSCORE (difference between timeliness of bad versus good news recognition) and GSCORE (timeliness of good news recognition).