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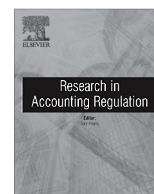


Research Report

# Accounting standard's effectiveness on equity overstatement – Conservatism when it matters ☆

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ABSTRACT

This paper evaluates the effectiveness of FASB's standards on accounting conservatism when a firm is likely overstating assets or understating liabilities. Specifically, this paper considers whether conservatism increases due to SFAS 87, 106, 121, 142, and 123R, conditional on the firm being an aggressive reporter. To test these standards, I perform two time-series analyses from 1976 though to 2010. The first analysis compares the number of observations with a book to market ratio (BTM) greater than one to all observations at the industry level. The second determines whether each standard is correlated with a reduction in the probability of a firm having a BTM greater than one. I use the BTM greater than one to identify firms that should be more conservative (avoid equity overstatement), and to exclude those that are biasing earnings to artificially low levels. The results are consistent with only some of the standards, SFAS 106 (*Employers' Accounting for Postretirement Benefits Other Than Pension*) and SFAS 142 (*Goodwill and Other Intangible Assets*), being effective in reducing equity overstatement.

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## Introduction

The purpose of this paper is to investigate the correlation between financial statement overstatement of equity and certain FASB standards. Specifically, this report investigates whether SFAS 86, 106, 121, 142, and 123R are correlated with firms increasing the recognition of liabilities or decreasing assets, leading to a reduction in shareholders' equity. Overstatement of equity on the balance sheet and the income statement leads to misleading underlying economic realities of firms and their performance. Indeed, most accounting scandals are a direct result of some form of equity overstatement. For example, Enron engaged in the practice of marking to market (among other illicit practices) its trading transactions specifically for the purpose of recognizing large unrealized gains (McLean & Elkind, 2004). From 1987 to 1991, Phar-Mor understated expenses and overstated inventory, cumulatively overstating net income by $290 million (SEC Litigation Release, 1995). Lastly, WorldCom recognized operating expenses as capital expenditures, improperly accounting for $3.8 billion, to increase reporting income from 1999 to 2002 (Pelliam, 2002). In response to these scandals, former SEC Chairman Richard Breeden said:

> *"I think a lot of companies got very aggressive during these boom times, and across the board we're going to see a move to greater conservatism, and long run, that's a very good thing." – Richard Breeden, former chairman, SEC.*

To counter the potential overstatement of shareholder equity (either though asset overstatement or liability understatement), as well as satisfy constituents and other stakeholder demands (see Bowen, DuCharme, & Shores,

☆ Data availability: The data used in this study are available from public sources identified in the text.

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1995), standard setters have periodically added regulations enforcing quicker recognition of certain liabilities or reductions in asset values.

This paper investigates whether the standards have been effective by considering whether a firm's book-to-market (BTM) ratio is greater than one. The BTM ratio is an important benchmark because it is a signal of the firm's degree of conservatism (Beaver & Ryan, 2000) and, barring equity overstatement, should not be greater than one. Firms with a BTM greater than one are unique in that, given an expectation of conservatism; they should not exist because book value should not exceed market value of equity. However, empirical results are consistent with between 13 and 17 percent of all observations having a BTM greater than one (see Danielson & Press, 2003 and Oler, 2011 respectively).[1] By comparing the number of observations with a BTM greater than one over time, I investigate whether new accounting standards are useful in reducing equity overstatement. In other words, I separate observations that adopt conservative accounting practices because shareholder equity is overstated (BTM greater than one) from those that adopt conservative accounting practices to bias their financial statements artificially low (see Levitt, 1998). This is of particular importance since this allows me to address whether the standards are appropriate for firms that are approaching fiscal distress as Oler (2011) finds that firms with a high BTM ratio tend to be less profitable and more likely to declare bankruptcy relative to the general population.

In a similar spirit to Kohlbeck and Warfield (2010), this paper investigates the attributes of certain accounting standards, but with a more narrow scope – are these standards effective in reducing equity overstatement on the financial statements? The primary goal of this paper is to provide empirical evidence for standard setters as they evaluate past standards and their effect on financial statements. Although prior literature has addressed the effectiveness of some standards on a stand-alone basis (e.g., SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, (Riedl, 2004), and SFAS 87, *Employers' Accounting for Pensions*, (Brozovsky, Murray, & Selto, 1993)), this paper incorporates several standards at once and specifically evaluates them based on their ability to induce greater conservatism incrementally to other standards. In addition to providing evidence on the effectiveness of accounting standards to the standard setters, this paper also provides informative data for other researchers when considering standards.

I perform my analysis by using two time-series tests. The first test is at the industry level and compares the ratio of observations with a BTM greater than one to total observations by industry-year. This ratio is then regressed on indicator variables that are equal to one after the successive accounting standards become effective. The second test is also a time-series analysis, but instead of at the industry level, I perform the analysis at the firm level using a probit regression differentiated by whether the BTM ratio is greater or less than one.

[1] I provide an example of a company with selected financial data that sees its BTM ratio climb above one in Appendix A.

The results from both tests are consistent with only certain standards being effective at increasing conservatism while two standards (SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* and SFAS 123R, *Share Based Payments*) are consistent with an increase in equity overstatement, although the result for SFAS 123R could be due to macroeconomic events. I find that SFAS 106 (*Employers' Accounting for Postretirement Benefits Other Than Pension*) and SFAS 142 (*Goodwill and Other Intangible Assets*) are both correlated with a reduction in the ratio of firms with a BTM greater than one and the probability of the observations' BTM ratio being less than one. SFAS 87, *Employers' Accounting for Pensions*, has mixed results. Under the industry level specification, SFAS 87 does not appear to have any effect on the number of firms with a BTM ratio greater than one. However, using the probit firm-level analysis, SFAS 87 is associated with a decrease in the probability that an observation will have a BTM greater than one.

It should be noted that this paper only considers equity overstatement that these standards address, and is not meant to be a criticism of these standards or FASB. Further, because I only consider standards that apply to asset overstatement (or liability understatement), this paper specifically focuses on conservatism as a means of reducing equity overstatement as opposed to a general bias in financial reporting. This is of particular importance since conservatism is, at times, used to mislead investors. For example, firm managers will use conservatism to defer income ("cookie jar") from periods of strong performance to periods of weak performance. The observations used in this paper are unlikely to be abusing conservatism and are, in fact, likely overstating equity.

The following section provides my hypotheses and Methods describes how I test the hypotheses. The Results section contains the findings and Conclusion provides some closing remarks.

## Theory

Although there has been a preponderance amount of research on conservatism (see Watts, 2003a for a general overview of the subject), much of it focuses on its attributes and how much it affects financial statements (for example, see Zhou, 2008 and Jenkins & Velury, 2011), as opposed to specifically addressing whether it reduces equity overstatement. However, in its original form, conservatism is a method of reducing, or reining in, over exuberant management. Indeed, Watts (2003a) identifies efficient contracting to reduce the moral hazard caused by the incentive for managers to overstate the firm's performance as a primary reason for conservative accounting.

Despite the contracting incentive for managers to be conservative, there is strong empirical evidence that firms are sometimes biased towards overstating the equity when reporting results. For example, Cheng and Warfield (2005) show a link between future insider stock sales and inflated earnings, (Erickson & Wang, 1999) provide evidence consistent with earnings management prior to a stock for stock acquisition, and Beatty and Weber (2003) show that

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