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Discussion of "The implications of unverifiable fair-value accounting: Evidence from the political economy of goodwill accounting"

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Abstract

Ramanna [2007. The implications of unverifiable fair-value accounting: evidence from the political economy of goodwill accounting, Journal of Accounting and Economics] provides interesting and novel evidence on how firms use contributions from their political action committees (PACs) to members of Congress as a means of lobbying for preferred positions on the two exposure drafts that led to SFAS-141 and SFAS-142. My discussion raises some concerns about his main conclusion: that pooling firms lobbied the FASB to obtain a "fair-value"-based impairment rule to facilitate their ability to manipulate financial statements. I offer a more benign explanation and make some other observations about how this line of research could proceed in the future.
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1. Introduction

As anyone who has followed the debate on accounting for stock options knows, politics plays an important role in accounting standard setting.[1] In spite of this, we know relatively little about *how* politics influences standard setting. Since the seminal work of Watts and Zimmerman (1978), there has been little in the way of formal empirical analysis of how the political process affects the decisions of accounting rulemakers, how firms lobby for preferred accounting positions, why firms prefer particular accounting positions, and so on.[2]

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[1] It is widely believed that political pressure forced the FASB to compromise its plans to mandate the use of the fair value method in the expensing of employee stock options (SFAS-123, issued October, 1995), and that changes in the political environment due to the accounting scandals earlier this decade enabled the FASB to subsequently reverse this decision in SFAS-123R (issued, December 2004). See, for example, Beresford (1997) and Zeff (2005b).

[2] Dechow et al. (1996) is an exception. See Zeff (2005a, b) for an interesting history of the influence of politics in U.S. standard setting, from 1930 to the present.

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Ramanna's (2007) paper is noteworthy for its willingness to address this void in the context of a recent and controversial accounting issue—accounting for goodwill (SFAS-142 "Goodwill and Other Intangible Assets"), an issue closely linked to accounting for business combinations (SFAS-141 "Business Combinations"). Perhaps most notably, Ramanna provides evidence on how firms use contributions from their political action committees (PACs) to members of Congress as a means of lobbying for these firms' preferred positions in the accounting standard-setting process.[3] He also provides evidence on the determinants of firms' lobbying positions on two exposure drafts that led to these standards. These two exposure drafts form the heart of his empirical analyses.

Ramanna concludes from his analysis that "pro-poolers" (firms that had previously used the pooling-of-interests method to account for business combinations) lobbied for an impairment-based goodwill standard to provide themselves with the ability to "manipulate" (his word) accounting after the standard. This follows from his assertion that SFAS-142, by requiring an impairment test for goodwill based on "unverifiable" fair value measurements, allows managers of acquiring firms to manipulate those fair values, and hence manage the reported numbers.

Although I agree with the general view that the increasingly widespread use of fair values is problematic when assets and liabilities are not traded in liquid secondary markets, making fair values difficult to verify, I am not convinced of Ramanna's rather strong conclusions. His conclusions essentially rest on the notion that firms were generally "abusing" pooling in the years prior to SFAS141/142, which he interprets as a propensity to manipulate. He then links this to what he sees as the unverifiable nature of the goodwill impairment test in SFAS-142 to argue that firms lobbied for this rule so that they could continue to manipulate. However, he does not specify clearly the form of this manipulation before or after the rule, and does not provide any direct evidence on these firms' manipulative behavior. Instead, his conclusions rest on the use of a number of relatively indirect proxies for manipulation.

An alternative perspective (which I label "functional fixation") is that firms prefer pooling because that method allows them to avoid recording and amortizing goodwill, as required by APB-17. Thus, as the number and value of acquisitions grew during the 1990s, the pooling abuse that regulators and standard-setters refer to is the increasingly aggressive interpretation of the pooling criteria, to the point that virtually all stock-for-stock deals qualified as poolings. The SEC was especially concerned about this practice because its staff had to spend increasing amounts of time evaluating and approving deals to see whether they satisfied the requirements for pooling.[4] This led to pressure on the FASB to readdress business combinations. At the same time, the FASB was facing pressure to move its standards towards those that were generally accepted internationally, which meant moving away from pooling. Given these pressures, it is not then surprising that the FASB initially proposed a rule that eliminated pooling and then, in the face of resistance, stood its ground on pooling but agreed to an impairment test (only) for goodwill, a compromise that avoided the periodic amortization of goodwill.

The pooling literature generally supports the perspective that firms' preference for pooling was related to managers' incentives to report higher EPS. For example, Lys and Vincent (1995) show that AT&T paid out somewhere between $50 and $500 million to satisfy the pooling criteria and boost EPS by 17% without affecting underlying cash flow.

In the next section, I discuss and evaluate the main arguments in the paper in more detail, and put it in the perspective of the events that led up to ED201 and the literature on business combinations. Section 3 summarizes and discusses the main aspects of Ramanna's evidence. Section 4 concludes with some suggestions for future research in this area.

2. Main thesis of paper

One of the challenges that faces researchers interested in the political process is that the empirical analysis is often more a case study than a large-scale empirical test. The analysis is typically carried out in calendar time,

[3]See Farber et al. (2007) for an analysis of the use of PAC contributions in the recent controversy over accounting for employee stock options.

[4]According to Zeff (2005b), the SEC's Chief Accountant complained that his staff were spending 40% of their time evaluating whether deals met the criteria for pooling.

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