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Disclosure transparency about activity in valuation allowance and reserve accounts and accruals-based earnings management

Cory A. Cassell[a], Linda A. Myers[a,*], Timothy A. Seidel[b]

[a] University of Arkansas, Fayetteville, AR, United States
[b] Utah State University, Logan, UT, United States

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ABSTRACT

We examine the relation between the transparency of disclosures about activity in valuation allowance and reserve accounts and accruals-based earnings management. We classify disclosures as being transparent if they provide detailed information about activity in the allowance and reserve accounts during the fiscal period. We find strong evidence that the extent of accruals-based earnings management is lower among companies with transparent disclosures than among companies without transparent disclosures. We also investigate whether the extent of accruals-based earnings management is lower for companies that provide transparent disclosures in one comprehensive schedule (i.e., the Schedule II) relative to those that provide transparent disclosures spread throughout the notes to the financial statements. Although regulators have expressed concern that the omission of a Schedule II could indicate a greater likelihood of earnings management, our results indicate that it is the omission of transparent disclosures rather than the omission of a comprehensive schedule outlining activity in the allowance and reserve accounts that affects earnings management. Our findings suggest that regulators, auditors, and investors should consider subjecting companies that fail to provide transparent disclosures to additional scrutiny.

1. Introduction

Accruals-based earnings management can be costly because questionable accounting practices are likely to be scrutinized by external auditors, investors, the board of directors, regulators, and other stakeholders. Valuation allowances and reserves provide managers with substantial flexibility to manage earnings because they are based on subjective estimates and are evaluated at higher levels of materiality, making them inherently difficult to audit (Griffith, Hammersley, & Kadous, 2013; Peecher, Schwartz, & Solomon, 2007; Peecher, Solomon, & Trotman, 2013). In addition, any differences identified by the auditor are more likely to be waived when the underlying accruals are more subjective (Joe, Wright, & Wright, 2011; Knapp, 1987; Wright & Wright, 1997). Thus, prior research suggests that companies are more likely to attempt to manage reported earnings using these types of accounts.[1]

We examine the relation between the transparency of disclosure related to activity in valuation allowance and reserve accounts and accruals-based earnings management, where disclosures are classified as being transparent if they provide detailed information about activity in the accounts during the fiscal period (e.g., information about the current period expense accrual, write-offs, etc. for the allowance for doubtful accounts).[2] The U.S. Securities and Exchange Commission (SEC) has long required that activity in subjective accrual accounts be disclosed. Specifically, within Regulation S-X, which prescribes the format and content of financial reports filed under the Securities Act of 1933 and the Securities Exchange Act of 1934, Rule 5-04 and Rule 12-09 require that companies file a Schedule II.[3] The Schedule II should provide the beginning and ending balances and the current period activity in

* Corresponding author.

[1] For example, Nelson, Elliot, and Tarpley (2002) use a field-based questionnaire in which 253 auditors from one Big 5 audit firm described 515 specific instances in which they believed that their clients were attempting to manage earnings. The authors indicate that "by far the most frequently identified attempts involve reserves" (Nelson et al., 2002, 176).

[2] Barth and Schipper (2008) define financial reporting transparency as the extent to which financial reports reveal an entity's underlying economics in a way that is understandable by those using the financial reports. Bushman, Piotroski, and Smith (2004) define corporate transparency as the widespread availability of firm-specific information about publicly listed firms to parties outside of the firm. Our definition of transparency is specific to our setting and relates to just one aspect of overall reporting transparency, but it is consistent with definitions set forth in prior research.

[3] Schedule II is a supplemental schedule filed with the company's form 10-K and is typically located after the footnotes to the financial statements. Laws requiring the use of Schedule II can be traced to 37 FR 14602 (passed on July 21, 1972) and re-designated and amended in 45 FR 63679 (on September 25, 1980).

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all material valuation allowances and reserves. The SEC exempts companies in certain industries,[4] companies with immaterial balances in the valuation allowances and reserves, and companies that provide comparable disclosures in the notes to the financial statements from the Schedule II requirement. Thus, under current SEC regulations, companies are required to provide transparent disclosures for material allowance and reserve balances in either a Schedule II or in the notes to the financial statements.[5]

Although the SEC requires transparent disclosure for material allowance and reserve balances, we find that compliance is lacking. Specifically, when we examine companies where the aggregate prior year balance of the allowance for doubtful accounts, inventory valuation allowance, and deferred tax asset valuation allowance is greater than one cent per share, thus removing companies that would not be able to increase current year earnings per share (EPS) by at least one cent even if they were to fully eliminate these accruals, we find that approximately 30% fail to provide transparent disclosures (either in a Schedule II or in the notes to the financial statements).[6] Although the following statement made by Ronald A. Kima, a former Assistant Chief Accountant for the SEC, focuses on problems associated with Schedule II compliance, it captures the potential implications of non-transparent disclosure in general,[7]

> Unfortunately, despite such schedule being required of most public companies, few companies seemingly fully comply. The absence of otherwise required data, or worse the outright omission of the schedule in its entirety, should raise investor concerns that a company may be engaging in some degree of inappropriate earnings management… Any immateriality assertion by a company's management that has been predicated exclusively on balance sheet measures is, at best, inappropriate and, at worst, an attempt to conceal inappropriate earnings management practices.

Consistent with claims in Kima (2007), we expect that companies will use allowances and reserves to manage earnings if the probability of detection is sufficiently low and if the combined magnitude of these accrual accounts is sufficiently large (so that their manipulation can have a meaningful effect on reported earnings). With respect to the first condition, we posit that non-transparent disclosures about highly subjective accrual accounts provide managers with flexibility to influence the market's perceptions of earnings. Because market participants face limitations when processing accounting information (Hirshleifer & Teoh, 2003), they may be less likely to see through the earnings management when companies disclose allowance and reserve accounts non-transparently. Although prior research does not investigate the association between accruals-based earnings management and the transparency of accruals disclosures, evidence suggests that managers use the flexibility in disclosure rules to engage in real earnings management (Lee, Petroni, & Shen, 2006) and that transparent disclosures facilitate investors' ability to detect earnings management (Hirst & Hopkins, 1998).

Because disclosures of allowances and reserves must be hand collected, we focus our analyses on the three accounts most commonly included in a Schedule II – the allowance for doubtful accounts, the valuation allowance for deferred tax assets, and the valuation allowance for inventories.[8] We hand collect disclosures for all companies in non-exempt industries that include at least one of the three allowance and reserve balances in a Schedule II, in the notes to the financial statements, or parenthetically in the balance sheet in their 2008, 2009, or 2010 annual reports.

We first investigate whether disclosure transparency for a given allowance or reserve account affects discretion in that account. Following Marquardt and Wiedman (2004), we estimate the expected balance in each account by multiplying the prior year balance by the current year growth rate. To further refine this measure for the allowance for doubtful accounts, we also multiply by the growth in days sales outstanding (to capture the change in collectability). Similarly, for the inventory valuation allowance, we multiply by the growth in days inventory outstanding (to capture the change in inventory turnover). Our measure of the discretion in each allowance and reserve account is the difference between the actual account balance and the expected balance. For each account examined, we limit the sample to companies where the disclosed beginning balance is at least one cent per share. We contrast discretion in the individual allowance or reserve account for companies that provide transparent disclosure (either in a Schedule II or in the notes to the financial statements) with that for companies that provide non-transparent disclosure. We find that discretion in the each of the three accounts, the allowance for doubtful accounts, the valuation allowance for inventories, and the valuation allowance for deferred tax assets is greater (i.e., more income-increasing) when these accounts are disclosed non-transparently.

Although we focus on the three allowance accounts most commonly included in a Schedule II (and not on all valuation and qualifying accounts that could be included in the schedule), we supplement our primary tests by examining broad measures of earnings management. In these tests, we contrast overall discretion in accruals for companies that provide transparent disclosures for all material (disclosed) allowance and reserve balances (either in a Schedule II or in the notes to the financial statements) with that for companies that provide non-transparent disclosures for all disclosed allowance and reserve balances. We find that companies that provide transparent disclosures report smaller signed, absolute value, and positive (income-increasing) discretionary accruals than do companies that provide non-transparent disclosures.

Having established a negative association between disclosure transparency and the extent of earnings management in subjective accrual accounts, we next investigate whether the placement of transparent disclosures matters. As evidenced by the rules surrounding Schedule II and by subsequent (defeated) regulatory proposals which would have required that a Schedule II be included in

[4] Excluded companies include registered investment companies, insurance companies, bank holding companies and banks, and brokers and dealers.

[5] Note that because Rule 5-04 does not provide a definition of materiality, materiality is left to management's discretion. In 2000, the SEC proposed a rule which would have required a disclosure similar to Schedule II in the notes to the financial statements, rather than as a supplementary schedule (SEC, 2000). The relocation of this disclosure would have provided increased prominence and auditor responsibility for the disclosure. The majority of comments received on the SEC's proposed rule opposed the proposal. The SEC did not finalize the proposed rule, so Rule 5-04 of Regulation S-X remains applicable and materiality thresholds continue to be subjective.

[6] To further support this finding, we use the Audit Analytics SEC comment letter database to identify SEC comment letters with specific reference to Schedule II or to the allowances most frequently included in a Schedule II. Our search resulted in many examples of the SEC requesting increased disclosure of the activity in allowance and reserve accounts (in accordance with Rule 5-04 of Regulation S-X).

[7] See SEC Schedule II – Visibility into the integrity of reported results. *AICPA CPA Insider Newsletter* (October 1, 2007). Retrieved from http://www.cpa2biz.com/Content/media/newsletters/cpainsider/cpainsider071001.jsp.

[8] In addition to being the accounts most commonly included in Schedule II disclosures, these accounts have also been the focus of prior research examining earnings management in specific accounts. See, for example, McNichols and Wilson (1988), Schrand and Wong (2003), Frank and Rego (2006), and Cecchini, Jackson, and Liu (2012).