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Discussion of Write-Offs as Accounting Procedures to Manage Perceptions

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The paper by Elliott and Shaw reports the results of a descriptive study of various characteristics and consequences of large write-offs (i.e., big baths). While the main focus is on the earnings and stock price performance of a sample of firms with large write-offs, data on the timing, magnitude, and form of disclosure for large write-offs are also provided. The authors motivate their paper by policy considerations, citing recent FASB and SEC interest in write-offs.

The conference discussion focused on the heterogeneity of write-offs with regard to motives, economic circumstances, and degree of anticipation by investors and the resultant implications for design of the tests. Pursuant to this, participants offered several suggestions for other dimensions on which the sample could be described. Additionally, some participants made suggestions for motivating some of the tests in order to clarify what is learned from the empirical analysis. Conference participants' comments and subsequent revisions to address those concerns are summarized in section 2.

In my opinion, the primary concern underlying the conference discussion is the paper's failure to identify and consider managers' economic incentives in making decisions to affect income via large write-offs. In fact, the explicit consideration of economic incentives allows the researcher to structure empirical tests to address specific questions, thereby defining a unique direction to the analysis. I provide some comments on this issue in section 3, in the interest of suggesting areas for future research.

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2. *Summary of Conference Discussion and Subsequent Revisions*

2.1 CONFERENCE PARTICIPANTS' REMARKS

Much of the conference discussion focused on how alternative write-offs may differ and, in turn, lead to differences in earnings or stock price performance. Differences in write-offs can arise from heterogeneity of both motives for and circumstances surrounding the write-off transaction. It was suggested that these differences can serve as a basis to partition sample write-offs for the empirical tests and lead to better identification of factors related to write-off decisions.

Some participants noted the possible relationship between write-offs and corporate control transactions. One participant noted that a corporate restructuring in conjunction with share repurchases had the appearance of a takeover defense. It was suggested that the authors investigate the incidence of takeovers and takeover attempts in their sample both before and after the bath, perhaps using 13-D filings.[1] Moreover, the possibility of a takeover may affect the manner in which investors react to the news of a write-off. This suggests that sample firms with prior takeover attempts could be examined separately in the stock price tests. Further, partitioning the sample into write-offs from restructurings vs. asset impairments as well as separately investigating restructurings in conjunction with share repurchases would be useful.

Other participants raised questions about the performance of sample firms in years prior to the year of the write-off. It was noted that apparent deterioration in earnings could be driven by reductions in the scale or scope of the firm's operations. To discriminate this effect from declining performance in the firm's continuing operations, it was suggested that Elliott and Shaw analyze firms' asset dispositions in prior years. Such an analysis may isolate cases where the write-off is, to a greater extent, an "unexpected" event. Focusing on cases where investors are less likely to have anticipated the write-off would make the stock price effects of such transactions easier to isolate.

The events of the bath year may also be to linked to future events in similar fashion. Some participants noted that current write-offs may convey differing implications regarding write-offs in future years. For instance, if the write-off occurs at the start of a corporate restructuring program, then the current write-off may imply an increased probability of future write-offs. One participant suggested that data on the relative importance of current- vs. future-period effects of the write-off could be gleaned from firms' statements of cash flows. Additionally, it would be

[1] These are filings mandated in section 13(d) of the Securities Exchange Act of 1934 as amended in the Williams Act. Briefly, within ten days of acquiring a 5% share of the equity of a firm, the acquirer must file a report with the SEC containing information about his identity, the source of funds for the purchase, and any plans to alter the structure of the acquired firm if the intent of the purchase is to acquire control.

informative to investigate the incidence of further write-offs following big baths. Data on these effects could, in turn, be linked with the stock price reaction to the initial write-off.

Several participants raised general concerns about motivation which were not addressed to specific aspects of the paper. The primary concern inherent in these comments was that the empirical results were difficult to interpret since the specific issue to be addressed with the tests was not explicitly stated. Some participants suggested that it might be possible to identify the reasons underlying the FASB's interest in the general issue of asset impairments (which lead to write-offs) as a means to structure the descriptive analysis.

Conference participants raised a set of concerns about specific technical aspects of the empirical tests which seem important. First, in one of their tests, Elliott and Shaw investigate the empirical relationship between the stock price reaction to the write-off and management's description of the write-off in the annual report. In all cases, management's discussion in the annual report follows public disclosure of the write-off. One participant noted that some managers might evaluate the write-off based partly on how shareholders react to it. If so, interpreting any empirical relationship between price reactions to announcement of the write-off and management's subsequent discussion in the annual report is tenuous, at best.

Second, one participant noted that further description of sample write-offs in terms of time and industry clustering would be helpful. Presumably, such an analysis would provide evidence on any problems of cross-sectional dependence in the data. Third, it was suggested that the 65 cases omitted in the data collection phase be brought back into the sample. The purpose of including these cases is that they provide an interesting benchmark to compare to the primary sample. While these 65 write-offs are not from restructurings or asset impairments, many are to some extent within management's control.

Finally, participants raised concerns about the focus on medians in the tests as well as reliance on the Wilcoxon test for drawing inferences. It was suggested that focusing on the median while not reporting other summary measures (e.g., mean, range, etc.) of the variables examined results in a loss of information. In addition, it was suggested that application of the Wilcoxon test to distributions skewed under the null can lead to a greater frequency of false rejections of the null.

2.2 REVISIONS TO ADDRESS CONFERENCE PARTICIPANTS' CONCERNS

Several revisions have been made to address conference participants' concerns. My intent in this section is to identify major revisions and evaluate whether issues raised at the conference are resolved.

First, the authors changed their cross-sectional regression to explain variation in price reactions to write-offs. The variable capturing management's ex post evaluation of the write-off has been purged. Omitting this variable from the regression makes the results easier to interpret. In addition, the inclusion of 0–1 dummy variables for stock repurchases and write-off type (write-down vs. reorganization) is a parsimonious way to address concerns raised at the conference about heterogeneity of write-offs. On the downside, the addition of the bad news variable to the regression to control for simultaneous releases is, by the authors' admission, subjective. The ad hoc nature of this variable makes interpretation of its coefficient difficult.

Elliott and Shaw also provide descriptive data on the frequency of corporate control transactions for their sample firms. Unfortunately, their analysis of takeover-related events is uninformative. They employ a source (*Wall Street Journal Index*) which yields noisy data rather than the more comprehensive data provided in SEC filings. They also provide no benchmark against which to gauge the evidence they report. Without data on similar events in a sample not taking write-offs, it is impossible to evaluate the economic significance of the frequencies they report. Given the weaknesses in this analysis, no firm conclusions about the role of corporate takeovers in write-offs are warranted.

Finally, the authors have incorporated some evidence on the characteristics of dividend and bond-rating changes as well as a discussion of the adequacy of disclosures accompanying the write-offs. The results on dividends and bond ratings are consistent with the rest of the study; firms taking write-offs are viewed as experiencing economic difficulties. However, since the authors provide no economic motivation for investigating these variables, it is unclear whether this extension adds much. The discussion of disclosure adequacy is motivated by participants' concerns about relations between current and future write-offs and cash flow effects. Given inherent problems in classifying narrative disclosures about write-offs, the authors' decision not to analyze these data systematically is appropriate.

3. *Some Thoughts on Economic Incentives*

A general question underlying many comments made at the conference is, what are managers' economic incentives to exercise discretion over reported income via large write-offs? Viewing earnings manipulation as optimizing behavior by corporate managers necessitates consideration of, at least, three elements of this choice: (1) managers' fundamental preferences (e.g., current-period bonus maximization) which provide incentives to manipulate income; (2) institutional mechanisms (e.g., the firm's auditors) which act to constrain manipulative behavior by the manager by imposing costs when the manager undertakes certain actions or adverse outcomes occur; and (3) alternative ways to manipulate reported earnings (e.g., altering accruals via accounting manipulation vs. altering real decisions which, in turn, affects reported income). The first element of this set has been considered in the literature from the perspective of compensation, corporate control transactions, labor negotiations, and regulatory intervention.[2] Consequently, I shall focus on the latter two elements.

3.1 COSTS OF EARNINGS MANIPULATION

The Elliott-Shaw paper does not address the effects of costs borne by the manager which are imposed by institutional arrangements designed to constrain managerial discretion over large write-offs. Such constraining forces could arise from the actions of firms' auditors, such as audit qualification or termination of the engagement. In addition, shareholders may be able to alter managerial incentives to exercise discretion over write-offs by the threat of lawsuit since income manipulation is actionable as a fraud under the federal securities laws.[3] While a full analysis of these issues is well beyond the scope of the Elliott-Shaw paper, I believe they present interesting avenues for future research.

One possibility would be to investigate the relationship between the magnitude and timing of large write-offs and audit qualifications or auditor changes. Such an analysis could seek to determine whether firms have different write-offs in the time period before they experience a qualification or auditor change. Such a relationship would suggest that choices of the auditor which imposed costs on the firm were conditioned upon manipulative actions by managers. Alternatively, it might be possible to document the effects of potentially manipulative behavior on audit fees. If income manipulation increases the probability of lawsuit, this should be reflected in higher fees to the extent that the auditor is exposed to greater risk of litigation.[4] This suggests it would be worthwhile to investigate the relationship between write-offs and subsequent increases in audit fees.

Regarding investor lawsuits, Kellogg [1984] documents significant negative abnormal returns associated with "discoveries" which lead to class action lawsuits under select provisions of the federal securities laws. The most pronounced price effects in Kellogg's sample are associated with changes in asset realizable values (i.e., write-offs). Extensions link-

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[2] See Healy [1985], DeAngelo [1986], Liberty and Zimmerman [1986], and Jones [1988].

[3] An extreme case is Ampex Corporation in the early 1970s. Ampex, an exchange-listed firm, reported income of $12 million for 1970. For fiscal 1972, the firm reported a loss of $90 million, including various write-downs totaling $58.7 million. The firm's auditors refused to certify the 1972 financial statements and withdrew certification for the 1971 statements because of uncertainty about whether the 1972 loss was attributable entirely to that year. As a result, the firm, its primary officers, and auditors were sued in a class action for violation of section 10(b) of the Securities Exchange Act of 1934 (and Rule 10B-5 promulgated thereunder by the SEC). The class of plaintiffs in this suit comprised all investors who bought Ampex shares in the 27-month period between release of the 1970 and 1972 annual reports (about 120,000 transactions involving 21,000,000 shares). For further details, see Blackie v. Barrack 524 F2d 891 (1975).

[4] See Simunic [1980] for an analysis of the determinants of audit fees.

ing the Elliott-Shaw paper with Kellogg's analysis could focus on identifying the characteristics which distinguish firms sued and not sued over write-offs. Such factors might include (1) size of the write-off, (2) the firm's profitability in prior years, (3) stock price declines prior to and coincident with the write-off, (4) trading volume in the security prior to the write-off, and (5) response of the auditor to the write-off.[5] These factors may also be associated with the stock price reactions to the write-off if it induces revisions in the probability of lawsuit by investors. Finally, to the extent that corporate control motives are operative in managerial choice over write-offs, lawsuits under provisions dealing with tender offers and other business combinations may be worthy of examination.[6]

3.2 ALTERNATIVE OPPORTUNITIES FOR INCOME MANIPULATION

The Elliott-Shaw paper also does not explore the relation between write-offs and other discretionary actions which can be taken by managers to affect reported income. This relation seems particularly important in dealing with large write-offs, given their high visibility. Presumably, the reason for income manipulation in the first place is to effect wealth transfers. The extent of such transfers depends partly on whether the party adversely affected by the action to transfer wealth can observe those actions. Since write-offs are so readily observable, questions arise about their relationship to other income manipulative actions.

First, there is the question of whether large write-offs are a cause or an effect of earnings manipulation. That is, do current-period write-offs reflect management's discretion in prior years? This question could be addressed by analyzing whether write-off firms differ from other firms in terms of exhibiting behavior which is consistent with income manipulation prior to the write-off. As a specific example, another paper presented at this conference (see McNichols and Wilson [1988]) deals with empirical estimation of discretionary accruals for bad debts. To see whether write-offs appear to be an effect of prior manipulative actions, one could test whether firms experiencing large write-offs for receivables exhibit lower than expected provisions for bad debts in the years prior to the write-off.

[5] Size of the write-off and the firm's prior profitability affect materiality. Stock price declines would be important since the plaintiff must demonstrate damage from the misrepresentation. Trading volume is also important because in some civil suits (most notably those under Rule 10B-5) standing to sue is granted only to those who engaged in actual securities transactions and not to shareholders who held over the entire period of misrepresentation. The response of the auditor may be important if it provides a signal of information to potential plaintiffs about the likely payoffs from bringing suit. For details of legal liability under the federal securities laws, see Loss [1983].

[6] Sections 14(a) and 14(e) of the Securities Exchange Act of 1934 deal with disclosures in proxy statements and in connection with tender offers, respectively.

Second, the high visibility of baths, along with their material adverse income effects, may induce management to undertake concurrent actions to buffer the effects of the bath. For example, managers facing large asset write-offs might undertake other asset disposition or debt retirement/defeasance transactions to book a gain which will offset the income effects of the write-off.[7] A thorough descriptive analysis of the incidence of other significant transactions around the time of asset write-offs could be useful in documenting related managerial choices.

Finally, the primary emphasis in the Elliott-Shaw paper is on cases where a given real event is fixed (e.g., asset impairment) and then the firm has discretion over how the event is reported (i.e., its timing and magnitude). Alternatively, consider cases where accounting treatment is fixed but the event giving rise to income effects is at least partially within management control (e.g., litigation settlement).[8] The issue here is the trade-off managers face in altering the properties of earnings via accounting decisions vs. real decisions.[9] While this is a difficult issue to resolve, a useful starting point would be the investigation of firms taking write-offs where the accounting treatment is fixed but management can exercise control over the timing of the underlying transaction.

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[7] Firms successfully employing this strategy would not appear in the Elliott-Shaw sample since they confine attention to cases where aggregate special items on *Compustat* exceed 1% of total assets.

[8] It has long been recognized that litigation outcomes can be modeled as endogenously determined by simultaneous optimizing behavior of plaintiffs and defendants (e.g., Gould [1973]).

[9] Lambert [1984] provides a model of managerial incentives to smooth income by altering real decisions.