Discussion: "Analysis of the Impact of Accounting Accruals on Earnings Uncertainty and Response Coefficients"

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I am delighted to have this opportunity to comment on Jerry Feltham and Jinhan Pae’s paper, "Analysis of the Impact of Accounting Accruals on Earnings Uncertainty and Response Coefficients." Accruals constitute the heart of the system of accounting and financial reporting. It is accruals that distinguish accounting from mere counting of cash. Accrual accounting can be defined by the presence of liabilities and noncash assets on the balance sheet. Without accruals, there would be no liabilities and no assets except cash. Accruals require accountants to anticipate the future, and make difficult judgments about events that are uncertain and yet to occur. A greater part of accountants' professionalism consists of making these judgments. Many people who thought that accountants might be replaced by computers are surprised that 40 years later, no such substitution is in sight. While a large part of bookkeeping can be, and has already been, taken over by computers, determination of accruals has not, and cannot be, taken over by computers. In this sense, accruals are the essence of accounting.

Which anticipations about the future should be included in the books of account and financial reports, and which ones should be deferred until a later date? Which ones are, in fact, included, and with what frequency? What are the consequences of different answers to these questions for the relationship between financial reports and security prices? These are critical issues that have been before managers, accountants, security analysts, and regulators for at least the past hundred years since the joint stock companies and stock and bond markets became an important part of the U.S. economy. With the explosion of derivative securities in the recent decades, triggered by the cheaper transaction technologies, these questions about accruals have become both more difficult as well as more important.

I therefore look forward to research that promises new insights into the nature and consequences of accruals. For this reason, and knowing Professor Feltham's seminal contributions to accounting in the past, I accepted Professor Callen's invitation to discuss this paper with alacrity.

I admit to being disappointed on the basis of what I have been able to understand of the paper. The paper opens with a reference to Feltham and Ohlson's 1996

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These comments were prepared based on the original version of the Feltham-Pae paper presented at the Conference. Editor.
article about the theory of depreciation measurement. In that article, it is assumed that information available to shareholders is independent of accounting. Such a framework could be of limited value at most in understanding the link between accounting accruals and security returns. While references to that article are repeated at least a dozen times, the present paper does not get around to telling the reader what it is going to tell us about accruals.

When the authors do not tell the reader succinctly what is in the paper, and why it is important, it is incumbent on us to read it carefully to try to learn what we can from it ourselves. Here is what I think the paper tells us.

- First, if managers add noise to the income they report, the income reported becomes noisier.
- Second, if managers report more of what they know, the reports depend on what they know and report.
- Third, if managers add noise to the income they report, correlation between what they report and market response to the report declines.
- Fourth, analysis of more complex accruals will require more complex models.

I have tried to understand what is new or interesting about these statements. I do not dispute them. Nor do I hold their simplicity or transparency against them. Most radical insights share the admirable properties of simplicity and transparency. However, in order to be valued, we must learn something about the world we are trying to understand. What are the real-world phenomena into which the authors' work might provide us some insights?

Financial reports can be seen from many points of view. Of these, most important and relevant points of view in the present context are the manager's and the shareholder/analysts' points of view. Let us look at these two perspectives.

Virtually all management decisions affect the financial reports. In preparing the financial reports, the manager makes a large number of decisions. The paper refers to operating cash flows of the firm as "premanaged." In what sense are the operating flows of the firm not managed? Perhaps the intention here is to think about management of accruals in isolation from the other instruments of income management available to the managers. These include the nonaccrual accounting instruments such as changes in accounting principles and revisions of accounting estimates. Even more important are the nonaccounting instruments of income management. These include timing of investments, sales and purchase transactions, mergers and acquisitions, disposal and disinvestment of assets, product strategy, pricing, and distribution. With so many real accounting instruments available for use, it is not unreasonable to expect that the firms who wish to manage their earnings would choose one or more instruments of income management from this portfolio available to them.

If our intent is to obtain insights into how and why firms manage their earnings, it is not likely that we can get meaningful insights into the process by focusing on
a single instrument of income management (accounting accruals) to the exclusion
of all other instruments available to management. Even if the intent were to un-
derstand how accruals are managed, ignoring the rest of the portfolio of instruments
is not likely to be helpful. To use an example from a different context, if Toyota
wished to study and understand the car buying behavior of consumers, it is not a
good idea to build our model on the assumption that Toyota is the only car the
consumer can buy. Yet, in studies of accruals management (as well as of income
management in general) by accounting researchers, it is typically assumed that the
accounting instruments are the only ones the managers have to choose from. The
fundamental distinction in the paper, managed versus premanaged variables, rests
on this shaky premise.

As far as I can tell, the paper gives results about managed and unmanaged
accruals without any model of managerial decisions or of decisions of those who
may read the financial reports. It is a mechanical model in which most things that
are important are specified as exogenous stochastic processes. Interaction among
the information of managers, their operating decisions, financial reports, and in-
formation available to the investors is more than a matter of calculating statistical
variances. During the year I spent visiting University of British Columbia many
years ago, I had the good fortune to learn from Professor Feltham how to model
accounting decisions and problems. Now I find myself at a loss to figure out what
to say about this paper that makes claims about management of accruals without
a model of management decisions.

In the limited amount of time I have, let me comment on Proposition 3: Ceteris
paribus, the more informative are managed accruals, the higher the earnings re-
sponse coefficient. Should we read it as a result or a definition? To find out, let us
reverse the proposition to: ceteris paribus, the more informative are managed ac-
cruals, the lower the earnings response coefficient. Does the proposition still make
sense? If not, perhaps we are looking at a definition, not a result.

These comments are based on my own assumption that the objective of the
paper is to try to understand accruals in the world of business. This may not be
fair to the authors because they repeatedly mention in the paper that the objective
of the paper is to expand what they refer to as “the Feltham-Ohlson 96 frame-
work.” I do not know what that goal means, nor am I able to assess how much
progress they make toward attaining that goal. Perhaps they will forgive me for
commenting on the paper using an old dictum: study nature, not books. If this
article, and any others, can help us gain a better understanding of accruals in the
world of business, the endeavor is worthwhile. Everybody in this room can do the
algebra. We cannot brush away the questions about where the specifications of
variables in the paper came from, and what they can tell us.

All models are really metaphors that seek to use our understanding of the
familiar to help enhance our understanding of the unfamiliar. I would like to close
with a metaphor. Some years ago, a friend gave me a ponytail barometer as a gag
gift. This consisted of a pony outlined on an 8 × 8 wooden board, with a tuft of
nylon fibers stapled for the tail. I was to hang the barometer in the open near the front door, and check the pony's tail periodically. The recommended mapping from condition of the tail to weather conditions was:

<table>
<thead>
<tr>
<th>Tail</th>
<th>=&gt;</th>
<th>Weather</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shaking</td>
<td>=&gt;</td>
<td>Windy</td>
</tr>
<tr>
<td>Wet</td>
<td>=&gt;</td>
<td>Raining</td>
</tr>
<tr>
<td>Dry</td>
<td>=&gt;</td>
<td>Clear</td>
</tr>
<tr>
<td>Missing</td>
<td>=&gt;</td>
<td>Tornado</td>
</tr>
</tbody>
</table>

Most, if not all of us, in the room have, at one time or another, written papers that could benefit from the ponytail barometer metaphor. It took me a while to make the painful connection to my own work. If the paper is no more useful to the reader to understand the questions addressed than this barometer is in forecasting, or even understanding the weather, we need to rethink what we are doing and why. Perhaps we should all keep one of these barometers.