Do Accounting Standards Motivate Strategic Investment Behavior? A Cross-Sectional Comparison of Investment Strategies in the U.S. GAAP and IFRS Reporting Environments

- We investigate whether firms engage in strategic transaction-structuring behavior around historically important equity ownership percentage thresholds. Historically, crossing over these thresholds triggered different accounting treatments, whereby companies had to recognize their proportionate share of an equity investee entity's net income or net loss and potentially also had to bring the assets and liabilities of the investee entity on their books, depending on the level of investment. This created incentives for companies to avoid having to recognize their proportionate share of investee net losses (required under the equity method) or bring large liabilities of investee entities onto their books (required under consolidation). Both U.S. Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS) require these accounting treatments if certain situational features are present. However, it was only more recent that the U.S. gravitated away from a primarily rules-based approach that focused on the ownership percentage toward a more principle-based approach to determining the accounting treatments. In contrast, IFRS have always been known for their principle-based approach. Now, the U.S. GAAP and IFRS standards are similar and look at whether the shareholder has significant influence or control in determining whether the shareholder has to apply the equity method or consolidate the investee.

- Yet, both sets of standards maintain "bright-line" ownership tests around the 20% threshold. There is a rebuttable presumption that a company has significant influence when it has an equity investment in an affiliate that is larger than 20%. We hypothesize and find that there is an unusually heavy concentration of investment among both U.S. GAAP-compliant and IFRS-compliant companies just beneath the 20% threshold.

- At the 50% threshold, we hypothesize and find evidence of transaction structuring behavior for U.S. GAAP-compliant companies. However, this same behavior is not evidenced for IFRS-compliant companies, suggesting that IFRS companies may be more faithfully applying the accounting principles, compared to U.S. companies. This is consistent with our expectation, given that IFRS has long since applied the concept of "de facto control" in determining whether or not a company has to consolidate an investee entity and, thus, bring the investee's assets and liabilities on its books.

- As a robustness test, we investigate the actual accounting practices of firms where possible to corroborate our belief that companies are investing strategically with an accounting motivation. (This is dependent upon data being publicly available that will allow us to determine the accounting treatment for a specific investee entity.) We find that, among the companies with adequate disclosure to determine this, 40.4% of U.S. GAAP-compliant companies who have equity investments larger than 40% but less than or equal to 50% are actually consolidating the investees, whereas 100% of U.S. GAAP-compliant companies who have equity investments larger than 50% but less than or equal to 60% are consolidating the investees.

- Our results suggest that, despite a transition to principle-based equity investment accounting standards in the U.S., companies continue to behave as if there is a "bright-line" test, suggesting that the accounting principles may not be faithfully applied.

FIGURE 1

Figure 1a: Graph of Ownership Distribution For U.S. GAAP-Compliant Firms

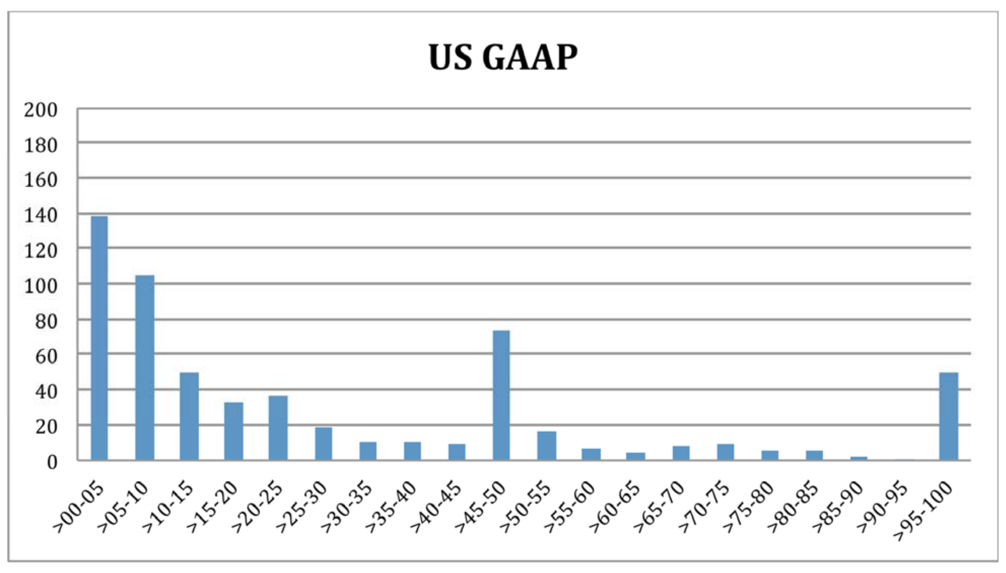
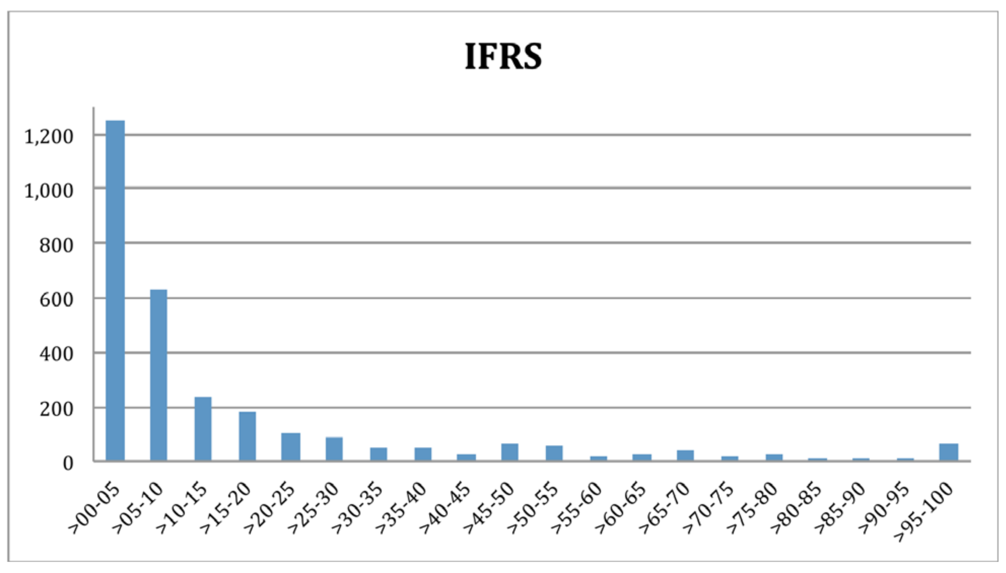


Figure 1b: Graph of Ownership Distribution For IFRS-Compliant Firms



Next Steps: We are performing further robustness tests to validate that our ownership data source is complete. We are also performing further robustness tests to rule out the possibility that the observed patterns of ownership are due to firms engaging in joint ventures. We are currently brainstorming about some additional final robustness tests that we can and should perform and we are presently seeking comments and suggestions as we revise the paper and prepare it for submission to an accounting journal in the next few weeks.

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