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An Analysis of the Financial Reporting Quality of Early Adopters of Accounting Standards Update, ASU 2016-02

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COLUMBUS STATE UNIVERSITY

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Abstract

In 2016, the Financial Accounting Standards Board updated the way lease transactions are reported. This paper offers insight into the financial reporting quality of the early adopters of Accounting Standards Update on Leases, ASU 2016-02. Methodology modeled after an event study on clawback provisions conducted by Dehaan, Hodge, and Shelvin (2013) aids in the development of the hypothesis and matched-sample event study using restatements and audit opinions as proxies for financial reporting quality. It is hypothesized that the early adopters of ASU 2016-02 will have better financial reporting quality when compared to a control group. Results do not support the hypothesis, so an additional analysis on the characteristics of the early adopters is conducted showing poor financial performance potentially explained by the Big Bath Theory.

Key words: lease, accounting standards update, financial reporting quality, financial characteristics, early adoption

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Introduction

In 2016, the Financial Accounting Standards Board (FASB), the authority on setting standards that appear in the FASB Accounting Standards Codification ("Accounting Standards Updates Issued", n.d.), reformed their reporting standards for leases (FASB, ASU 2016-02). For public companies that file financial statements with the Securities Exchange Commission (SEC), these new standards must be adopted and integrated into their financial reports for fiscal years beginning after December 15, 2018 [1].

The goal of this study is to gain insight into the financial reporting quality of the firms that have chosen to early adopt Accounting Standards Update 2016-02 in hopes that it will provide more information concerning the impact of the new standard to current accounting practitioners. More specifically, this study will provide insight into the nature of firms that choose to early adopt new accounting standards and the overarching factors affecting companies' decision-making when acquiring an increase in liabilities, as will occur under the adoption of the new leasing standard, or other standards updates that bring with them a perceivably negative financial impact. Based on prior research conducted by Dehaan, Hodge, and Shelvin (2013), it is hypothesized that firms that decide to early adopt an accounting standard update are often more concerned with financial reporting quality. Financial reporting quality can serve as an indicator of how ethical and financially transparent a firm is. By studying the relationship between the financial reporting quality of early adopters of ASU 2016-02 and their decision to adopt the update prior to the effective mandatory date, a better understanding of the situation

1 For other entities, the effective date is for fiscal years after December 15, 2019. There is one final effective date, December 15, 2020, for those companies using interim periods, or any period that is shorter than a fiscal year (FASB, ASU 2016-02). That being said, companies are permitted to adopt the standards prior to the effective date.

surrounding the new lease standard update is made. Findings show opposing results, so an analysis on the characteristics of the early adopters is also conducted.

Review of Literature

Background Information on ASU 2016-02 (Topic 842, Leases)

In 1976, FASB released the Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases* in order to establish reporting standards for leases by both lessees and lessors ("Summary of standard No. 13", n.d.). Under SFAS No. 13, there are two categories leases could be classified as – capital leases and operating leases. Capital leases occur when the lessor finances the leased asset and all other rights of ownership transfer to the lessee. A capital lease requires the recording of both an asset and a corresponding liability to the balance sheet. In addition, any lease that meets one or more of the four tests described in SFAS No. 13 is classified as a capital lease. These tests include a transfer of ownership at the end of the lease term, a bargain purchase option given to the lessee, the lease term is seventy-five percent or greater than the asset's economic life, and finally a present value test where the present value of the lease payment is at least ninety percent of the leased asset's fair market value (FASB, p. 8, 1976). All other leases that do not meet those requirements are classified as operating leases.

Unlike capital leases, operating leases are handled as an operating expense (FASB, 1976). To further illustrate the differences between recording a capital lease and an operating lease, a capital lease involves recording an asset and a liability. Along with recognizing the liability, a company will also record interest expense, because the leased asset is considered a loan. The company will also recognize depreciation expense, because the leased asset is included on the balance sheet, and assets depreciate over time. With an operating lease, the lease expense is recorded on the income statement. The lease expense is much smaller relative to the liability recognized under the capital lease. Because there is no liability recorded with an operating lease, there is also no interest expense.

Under this method, companies are prone to evade the standards by utilizing loopholes to report leases as operating leases rather than capital leases. For example, one of the determining tests when looking at leases is the bright-line test. Under the old standards, to be classified as a capital lease, the lease term will be seventy-five percent or greater than the asset's economic life and ninety percent of the fair value (FASB, p. 8, 1976). Companies, however, are able to manipulate certain numbers like the economic life of an asset and the fair market value in order to be able to report what should be considered a capital lease as an operating lease. By doing this, companies can avoid reporting liabilities on their balance sheet through off-balance sheet reporting. With operating leases, there is a lack of transparency in the company's financial statements that can occur. Companies are able to use off-balance sheet reporting to remove certain unfavorable accounts in order to create better looking financial statements (FASB, ASU 2016-02). For example, in order to avoid acquiring more debt than a company already has recorded, the company can use a subsidiary to purchase an asset and then lease it to the original company with an operating lease. Now the company only has to record an operating expense and does not have to record an additional liability or interest expense in their financial statements.

To improve the transparency, understandability, and decision-usefulness of financial reporting on leasing, the FASB issued Accounting Standard Update 2016-02, *Leases,* to supersede the standards set under SFAS No. FASB, ASU 2016-02). As explained previously, the new standards have a mandatory effective date of December 15, 2018 for public companies. For all other companies, there is a December 15, 2019 effective date and, for companies reporting on interim periods, an effective date beginning after December 15, 2020. Early adoption of the new standards is permitted (FASB, ASU 2016-02). Under the new standards, there are also two classifications of leases – finance leases, previously called capital leases, and operating leases. Like SFAS No. 13, there are still tests in order to classify a lease as either a finance lease or an operating lease. These tests share similarities with the previously used tests (FASB, ASU 2016-02). However, there is a striking difference between SFAS No. 13 and ASU 2016-02 in terms of how leases are recorded.

Under SFAS No. 13, operating leases are not recorded on the balance sheet thus limiting the amount of liabilities present. As explained in FASB Concepts Statement No. 6, every lease creates both a right-of-use asset and a corresponding liability (FASB, 1985). To absolve the ability to circumvent the classification of leases like companies were able to under the previous standards, firms are required to capitalize all leases with lease terms of twelve months or more (FASB, ASU 2016-02). Companies that have historically avoided capitalizing their leases by sidestepping the previously set standards will experience an increase in their liabilities as they capitalize their leases.

Off-balance Sheet Transactions

To provide a better understanding of the effects of off-balance sheet reporting, several brief examples will be discussed in the following section. Through the use of an off-balance sheet account, the Lehman Brothers were able to move billions of dollars of debt off of their balance sheet. This was done in an effort to appear more financially stable before the quarter's end. Once the end of the quarter had passed, the debt was brought back to the balance sheet. Lehman Brothers could not sustain this and soon went bankrupt (Hines, Kreuze, & Langsam, 2011).

In another infamous case of off-balance financing, Enron used special purpose vehicles to hide the company's debt. A special purpose vehicle owns an asset on behalf of a company and leases the asset to the company. In this case, the company will incur an operating lease expense off the balance sheet instead of a large liability from purchasing the asset outright. From there, the company would only have to record the small lease payments as operating expenses (Thomas, 2002). While these are dramatic scenarios of fraud and misrepresentation, efforts like these will be much harder to successfully complete with the new lease standards since companies' ability to have lease transactions off of the balance sheet is hoped to have drastically declined. To be clear, off-balance sheet items are not required to be reported on the balance sheet. However, it mitigates the possibility of misrepresentation and poor financial reporting quality if they are recorded on the balance sheet.

Hypothesis Development

Under ASU 16-02, the major change between the previous method of recording leases and the new standards is how a company must record their operating leases. According to the new standards, companies must capitalize operating leases that are longer than one year. As previously explained, companies are given the opportunity to either early adopt the new standards prior to the mandatory effective date or to wait until the mandatory date to begin integrating the new standard into their financial reporting. The previous analysis of the background of the new standard, ASU 16-02, gives the impression that financial statements are "unfavorable" compared to previous years.

Dehaan, Hodge, and Shelvin (2013) examine the effects voluntary adoption of a compensation clawback provision has on the improvement of financial reporting quality. Clawback provisions permit companies to recuperate compensation from executives contingent upon a predefined event meaning after a financial restatement due to misconduct, companies are required to attempt to repay any excess incentive compensation from CEOs and CFOs (DeHaan et al., 2013, p. 2). DeHaan et. al find that companies that voluntarily adopted the clawback provisions had an increase in financial reporting quality.

While Dehaan et al.'s major finding is that the companies that implement the clawback provisions have an increase in financial reporting quality, they also find that the companies that adopt the provision generally have better financial reporting quality prior to the implementation of the clawback provision than companies that did not. Therefore, voluntary adopters tend to be more ethical and transparent in their financial reporting. Rather than experiencing an increase in financial reporting quality, when Dehaan et al.'s findings are applied to the situation created by ASU 2016-02, companies that voluntarily adopt the standard early choose to adopt the new changes prior to the mandatory effective date, because they have better financial reporting quality.

Proxies

In Dehaan et al.'s research, they use several different proxies for financial reporting quality including restatements. Restatements are often indicative of a company's financial reporting quality, because restatements often occur when there has been an accounting error, clerical error, noncompliance with GAAP, or intentional fraud or misrepresentation. Companies with more restatements are likely to have lower financial reporting quality, whereas companies with less restatements are likely to have higher financial reporting quality.

In addition to using restatements, this study focuses on audit opinion as a proxy for financial reporting quality. Auditors provide five levels of audit opinions when conducting an audit on a company – unqualified, unqualified with explanatory paragraphs, qualified, adverse, and no opinion. Unqualified opinions are given to companies when their financial statements are free from material error or misstatements. Unqualified with explanatory paragraphs are given to companies when their financial statements are free of material error or misstatements but there is still a reason to explain a situation in more detail. Qualified are given to companies where there is a material error or misstatement due to a limitation of scope in the auditor's work or a lack of maintaining GAAP principles. With a qualified opinion, the error or misstatement must be material in nature. Lastly, when a company is given an adverse opinion or no opinion at all, there is a material issue that is pervasive enough to misrepresent the company's financial standing. No opinion given often means that after conducting preliminary risk evaluations, the auditor determined that the company was too risky to take on as a client.

Hypothesis

Based on previous, the following hypothesis has been developed:

H1: Voluntary adopters of ASU 2016-02 are more ethical companies with better financial reporting quality.

Financial reporting quality is measured using the similar proxies to the ones Dehaan, Hodge, and Shelvin have utilized in their research on clawback provisions. Due to the findings of Dehaan et al., I hypothesize that voluntary adopters are more concerned with being ethical and providing transparent, decision-useful financial statements to their financial statement users. In this study, "ethical" is defined as having better financial reporting quality. Therefore,

H1a: Voluntary early adopters of ASU 2016-02 will have fewer non-unqualified audit opinions than their nonadopting peers.

H1b: Voluntary adopters of ASU 2016-02 will have fewer restatements of financial statements than their nonadopting peers.

Methodology

In order to test these hypotheses, I use an event study following similar procedures to DeHaan's research along with other event-focused studies. The event study consists of a matched-sample comparative analysis relating the financial reporting quality of the early adopters of ASU 2016-02 to a group of nonadopters. The use of a matched-sample design controls for specific extraneous variables outside of the variables of interest. Variables that were controlled in this study include firm size and firm industry. The matched-sample design consists of a test group and a control group. Based on the data provided by CompuStat's database, there are eleven companies (Fig. 1) that have chosen to voluntarily early adopt ASU 2016-02. The control group consists of eleven firms of similar size and industry (Fig. 2).

The first comparative analysis consists of conducting a paired t-test to test the significance of the difference between the number of non-unqualified audit opinions for the early adopters and their matched firms. As explained previously, there are five different opinions that an auditor may deliver to a company. In this study, audit opinions are separated into unqualified and non-unqualified opinions. Unqualified opinions indicate better financial reporting quality than non-unqualified opinions.

The second comparative analysis consists of conducting another paired t-test to test the significance of the difference between the number of restatements for the early adopters and their matched firms. A higher number of restatements indicates a lower financial reporting quality.

Sample Firm Selection.

As briefly explained previously, the test group of companies consists of the companies that have voluntarily adopted ASU 2016-02 prior to the effective date. The early adopters are collected by filtering the financial statement data in CompuStat with "ASU 2016-02" and the year of adoption.

Early Adopters of ASU 2016-02			
Adopters	Industry	Adoption Year	Total Assets (000,000)
EnSync	Manufacturing	2016	34.272
Rangeford Resources	Mining	2016	0
Great Elm Capital Group	Finance, Insurance & Real Estate	2017	76.694
New Age Beverage	Manufacturing	2017	67.672
New Peoples Bankshares	Finance, Insurance & Real Estate	2017	666.7
Research Solutions	Services	2017	12.562
William Lyon Homes	Construction	2017	2061.104
YayYo	Services	2017	0.322
National Storage Affiliates Trust	Finance, Insurance & Real Estate	2018	2729.263
NextEra Energy Partners	Finance, Insurance & Real Estate	2018	9405
Schlumberger	Mining	2018	70507

Figure 1. Company Information for Year of Adoption

The test group is then matched to a control firm of similar size and industry. In this study, similar size of a company is determined by the Total Assets a company reports on their balance sheet in the same year that the test firm adopted the new standard. For example, if Firm A has 10,000 dollars in Total Assets the year it adopted ASU 2016-02, Firm A is matched to a non-adopting firm in the same industry and year with a firm that has the closest amount in Total Assets. Similar industry is determined by matching the Standard Industrial Classification (SIC) code for each firm in the test group to a firm of similar size and a similar SIC code. SIC codes are strands of four digits describing the industry that a firm is in where each digit identifies companies and their specific industry to a varying level of specificity. The first two digits of an SIC code indicates the major industry group; this is the broadest classification. An additional digit indicates the industry group, and the last digit identifies the specific industry (NAICS, 2018). While the SIC codes have not been updated since 1987 when they were replaced by the North American Industrial Classification System codes, the SIC codes are still consistently used by the SEC, private data sources, and academic researchers more frequently than the NAICS codes are being used ("SIC Codes vs. NAICS Codes", n.d.). Therefore, in a matched-sample design, it is advantageous to be able to match the SIC code of the firm in the test group to a firm with the exact same SIC code; however, in order to control for the size of the firm, in some cases it is necessary to choose firms that only match the first three digits, meaning the firms are of similar size in the same industry group, or in some situations only the first two digits, meaning that the firms are of similar size in the same major industry group. In this particular study, four-digit matches based on the test firm's adoption year of ASU 2016-02 and their total assets are difficult to make for a majority of the test group. In order to remain consistent throughout the data collection process, firms are matched on a two-digit SIC code. The industry match is more lenient in order to achieve a better match on firm size.

The following figure (Fig.2) displays the matched firms with the major industry group the firm operates in, the year from which the data was selected, and the total reported assets of the firm for that year.

Non-Adopters of ASU 2016-02 (Matched Firms)			
Adopters	**Industry**	**Data Year**	**Total Assets (000,000)**
Espey Manufacturing & Electronics	Manufacturing	2016	34.453
Tiger Oil and Energy	Mining	2016	0
Reven Housing REIT	Finance, Insurance & Real Estate	2017	65.587
Planet Green Holdings	Manufacturing	2017	68.488
Community Bancorp/VT	Finance, Insurance & Real Estate	2017	667.046
Zedge	Services	2017	12.531
Beazer Homes USA	Construction	2017	2220.995
My Size	Services	2017	2.418
Royal Gold Inc	Finance, Insurance & Real Estate	2018	2682.016
EQT Midstream Partners	Finance, Insurance & Real Estate	2018	9456.121
Conocophillips	Mining	2018	69980

Figure 2. Matched Firm Information for Year of Adoption

Results

Audit Opinion

Panel A: Total Number of Non-Unqualified Audit Opinion

Adopter		Non-Adopter	
Rangeford Resources	3	Tiger Oil and Energy	3
EnSync	1	Espey Manufacturing & Electronics	0
William Lyon Homes	0	Beazer Homes USA	0

New Age Beverages	1	Planet Green Holdings	3
New Peoples Bankshares	0	Community Bancorp/VT	0
Great Elm Capital Group	3	Reven Housing REIT	0
YayYo	1	My Size	0
Schlumberger	0	Conocophillips	0
NextEra Energy Partners	3	EQT Midstream Partners	0
National Storage Affiliates			
Trust	0	Royal Gold Inc	0
Research Solutions	0	Zedge	0

Panel B: Paired t tests (Difference: Adopter – Non-Adopter)

N	Mean	Std. Dev.	t Value	Pr > |t|
47 *	0.1277	0.4480	1.95	0.0569

Figure 3. Analysis of Financial Reporting Quality - Audit Opinion (2014-2018)

Analysis of Audit Opinion.

Based on the results shown in the figure above (Figure 3), the hypothesis cannot be supported at a 95% confidence level. Based on the mean difference, the hypothesis is not supported. In this case, the mean difference is the average difference between the number of non-unqualified audit opinions for the early adopters and the number of non-unqualified audit

* In theory, this number should be fifty-five, because the analysis is over the five-year period, 2014 to 2018. All eleven firms, however did not have financial data for all five years. For example, YayYo, Inc. only has one year (2017) of financial data reported. For this reason, the sample is forty-seven.

opinions for the non-adopters. The mean difference in this scenario is 0.1277, meaning that on average the difference between the average number of non-unqualified audit opinions is higher for the test group than their matched controls. Based on the framework research performed by Dehaan, et al., the early adopters are expected to have fewer non-unqualified audit opinions indicating that the test firms are more ethical and have better financial reporting quality. Because the mean difference for non-unqualified audit opinions is positive, it cannot be concluded that the early adopters have better financial reporting quality. Although it is improper practice to assume the alternative hypothesis when rejecting the null, the results of the t-test providing a p-value of 0.0569 indicate that the alternative hypothesis can be marginally supported at the 90% confidence level.

Number of Restatements

Panel A: Total Number of Restatement

Adopter		Non-Adopter	
Rangeford Resources	2	Tiger Oil and Energy	0
EnSync	0	Espey Manufacturing & Electronics	0
William Lyon Homes	0	Beazer Homes USA	0
New Age Beverages	1	Planet Green Holdings	1
New Peoples Bankshares	1	Community Bancorp/VT	0
Great Elm Capital Group	0	Reven Housing REIT	1
YayYo	0	My Size	0
Schlumberger	0	Conocophillips	0
NextEra Energy Partners	1	EQT Midstream Partners	1

National Storage Affiliates Trust	0	Royal Gold Inc	1
Research Solutions	0	Zedge	1

Panel B: Paired t tests (Difference: Adopter – Non-Adopter)

N	Mean	Std. Dev.	t Value	Pr > |t|
47**	-0.0213	0.4418	-0.33	0.7428

Figure 4. Analysis of Financial Reporting Quality - Restatement (2014-2018)

Analysis of Restatements.

The results of the paired t-test comparing the number of restatements for the early adopters and non-adopters also provide results that do not support the hypothesis that the financial reporting quality of the early adopters is better than the financial reporting quality of the control group. Based on the results of the t-test and the calculated p-value, the hypothesis cannot be supported at a 95% significance level. There is no significant difference between the number of restatements performed by the early adopters and the non-adopters. For this reason, the hypothesis cannot be accepted, but may indicate that the early adopters are not as concerned with financial reporting quality.

Discussion

Given that the data analysis provides results that do not support the hypotheses in question, an analysis on the characteristics of the early adopters provides more insight into the

** In theory, this number should be fifty-five, because the analysis is over the five-year period, 2014 to 2018. All eleven firms, however, did not have financial data for all five years. For example, YayYo, Inc. only has one year (2017) of financial data reported. For this reason, the sample is forty-seven.

lack of supporting results. In this analysis, I look at the test firms' basic performance including Net Income and Total Equity.

Analysis of Firm Performance

Year of Adoption.

Financial Characteristics of Early Adopters of ASU 2016-02 Year of Adoption (millions)			
Firm	**Adoption Year**	**Net Income**	**Total Equity**
EnSync	2016	-17.876	16.636
Rangeford Resources	2016	-1.254	-2.339
Great Elm Capital Group	2017	-15.207	66.226
New Age Beverage	2017	-3.536	52.738
New Peoples Bankshares	2017	3.094	50.973
Research Solutions	2017	-2.294	4.345
William Lyons Homes	2017	48.135	780.472
YayYo	2017	-6.569	-0.174
National Storage Affiliates Trust	2018	14.109	744.339
NextEra Energy Partners	2018	192	1798
Schlumberger	2018	2138	36162

Figure 5. Financial Characteristics of Early Adopters for the Year of Adoption

When looking at the Net Income and Total Equity of the test firms from the year of adoption displayed in Figure 5, a majority of the firms have poor performing numbers. Six of the eleven test firms reported a negative Net Income for the year ASU 2016-02 was adopted. This means that a majority of the test firms for the year of adoption have incurred more expenses than revenues and are not making a profit. In addition to negative Net Income, several firms have negative Total Equity. Negative stockholders' equity is a red flag to investors, because it indicates that the company has more liabilities than they have assets. If the company were to sell all of their assets today, there would be no money left for the stockholders.

In addition to the companies' Net Income and Total Equity being unfavorable for the year of adoption, a large percentage of the companies either have not reported their retained earnings on their balance sheet or have reported negative retained earnings. For example, of the companies that reported their retained earnings for the year of adoption, sixty percent had significantly negative values ranging from negative six million dollars to approximately negative eighteen million dollars. When recording negative retained earnings, the item on the balance sheet is often referred to as "Accumulated Loss". This accumulated loss is often another red flag to investors, because it indicates that the company has not been able to maintain a profit and may indicate serious financial problems (Jordan, et al., 2011).

2014-2018 Average.

Average Financial Characteristics of Early Adopters of ASU 2016-02 from 2014-2018 (millions)

Firm	Years	Net Income	Total Equity
EnSync	2014-2018	-11.3354	12.877
Rangeford Resources	2014-2016	-1.59533333	-1.87
Great Elm Capital Group	2014-2018	-11.6356	50.7972
New Age Beverage	2014-2017	-2.06825	14.5275
New Peoples Bankshares	2014-2017	1.7385	46.707
Research Solutions	2014-2018	-1.1126	2.8678
William Lyons Homes	2014-2018	60.2776	708.578
YayYo	2017	-6.569	-0.174
National Storage Affiliates Trust	2014-2018	9.495	445.3194
NextEra Energy Partners	2014-2018	45	1332.2
Schlumberger	2014-2018	1291.2	37513

Figure 6. Financial Characteristics of Early Adopters from 2014 to 2018

Figure 6 displays the test firms' Net Income and Total Equity averaged from the years 2014 to 2018. When looking at the average Net Income and average Total Equity of the test firms from these years, a majority of the firms still have poor performing numbers; six of the eleven test firms reported a negative Net Income. In addition to negative Net Income, several firms have negative Total Equity.

Relevant Theories & Potential Correlations

Related Studies.

While prior literature alludes to the idea that early adopters of accounting standards tend to have better financial reporting quality (DeHaan, et al., 2013), the results presented in this study do not support that idea.

In terms of potential reasons why the test firms appear to be underperforming, there are several theories. In a study conducted by Ayres, the characteristics of firms electing to early adopt a new standard for accounting for foreign currency conversion, SFAS 52, were analyzed in order to gain insight into the positive theory of accounting choice. In Ayres' study, it was found that typically the firms that elected to early adopt the new standard tended to be smaller in size than nonadopters and had less favorable financial ratios compared to nonadopters (Ayres, 1986).

Similar studies have been conducted. For example, in 1989, Trombley conducted a study that shows that most of the early adopters of SFAS 86, a standard concerned with computer software costs, were smaller in size than nonadopters much like the firms that chose to early adopt the standard from the previous example in Ayres' study (Trombley, 1989).

Big Bath Hypothesis.

Another theory for the negative nature of the adopting firms' financial performance could be explained by the Big Bath hypothesis. In 1973, Moore discussed the theory of the "Big Bath" concerning management changes and their relationship with discretionary accounting decisions. In this study, Moore explains that there are several reasons a company will decide to adopt discretionary accounting changes to include smoothing periodic income, creating ad hoc fluctuations in income, and maximizing or minimizing reported income (Moore, 1973, p. 100). This study performed by Moore specifically looked at the relationship between new management and the adoption of discretionary accounting changes. Even though the study detailed in this paper did not include the factor of new management's decisions, the overall theory can still be applied to the decision to adopt ASU 2016-02. Under the Big Bath hypothesis, management will take a negative outlook on how they value certain assets in order to increase the perception of the company in future years to appear as better performing. For example, a company will accumulate a one-time charge against its income in order to decrease the company's assets. By reducing its assets, in turn, the company has reduced its expenses for future periods. While the reduction of assets in the year of the bath results in a lower net income for that specific year, future years will have lower expenses thus increasing the company's income for following periods.

In general, the Big Bath hypothesis is applied to earnings management scenarios and asset valuation. In this study, while the new leasing standard creates more leased assets due to the capitalization of operating leases of one year or longer, the concept of asset valuation and earnings management are not necessarily at play in this situation. However, the Big Bath can be applied. With the adoption of new leasing standards, companies incur an increase in liabilities. Generally, companies try to avoid liabilities and debt for various reasons. Because many investors and financial analysts depend on companies' financial statements in order to make decisions, it would be advantageous for the company to create a big bath now while they are struggling, so that when and if they recuperate, the improvement is even more impressive than it would have been to investors, lenders, and other financial statement users.

Self-Selection Bias.

Lastly, a potential theory regarding the lack of conclusive evidence pertaining to the causal relationship between the financial reporting quality of the early adopters and their decision to voluntarily adopt the new lease standards can be attributed to self-selection bias. Due to the nature of the event, companies can select to adopt the new standards early or wait until the effective date. Because of this, companies can unknowingly group themselves into biased groups. Shehata (p. 768, 1991) explains that "self-selection bias arises from the use of truncated, nonrandom sample to assess the behavior of firms using different accounting methods at the time of the mandated change." With the small sample of firms that elected to early adopt the new standards, there is question as to whether or not the are random or nonrandom. With such a small, potentially nonrandom sample, supporting results are difficult to make and, therefore, conclusions and implications of the study are lacking as well.

Conclusion

Implications of Study

The goal of this study is to provide insight into the relationship between the decision to early adopt ASU 2016-02 and the company's financial reporting quality to accounting practitioners. Given the results, a general conclusion concerning the causation between of the financial reporting quality on the decision to early adopt ASU 2016-02 cannot be made. It is hypothesized that firms that choose to adopt the new lease standard prior to the mandatory effective date are more ethical, financially transparent firms. This is tested by looking at the financial reporting quality of the companies that decide to early adopt the standard compared to those that choose to wait until the standards update becomes effective. Upon conducting a matched-sample comparative analysis, it is found that the results of the paired t-test do not support the null hypothesis. For this reason, an analysis on the characteristics of the test firms is conducted. Based on the analysis, the firms appear to be poor performing firms. As discussed earlier, this can be explained by several potential theories, specifically the Big Bath Theory.

Areas for Future Research

Due to the opposing results of the study, it is difficult to take any implications away from this study. However, it does provide room for future areas of research. While this study looks at the financial reporting quality of the early adopters compared to non-adopters of ASU 2016-02, future research can examine the relationship between adopters and non-adopters in more detail, perhaps looking more closely at the performance of the industries as a whole rather than just a matched sample. For example, four out of eleven of the early adopters are in the major industry group called “Finance, Insurance, and Real Estate”. A future study concerning the characteristics of that specific industry may bring to light certain things that may be indicative of what type of firm chooses to voluntarily adopt an accounting standard update. Questioning why so many of the early adopters are from one or two major industry groups could be indicative of the performance of that industry as a whole, rather than the firms specifically.

Beyond examining the financial reporting quality of the early adopters, research concerning the motivations of the companies should be assessed in more detail. Although this study discusses the relationship to a certain extent, a more in-depth study focusing on applying the Big Bath Theory to the firms’ financial characteristics may provide more insight into the motivations behind the companies’ decisions to adopt the standards update prior to the mandatory effective date. A continuation from this study would provide insight into the effectiveness of the company's Big Bath decisions. Analyzing the financial standing, financial ratios, and analyst forecasts of the early adopters may provide more understanding into the application of the Big Bath Theory beyond earnings management. Often the Big Bath Theory is applied strictly to earnings management scenarios. If a study analyzing the performance of the early adopters of ASU 2016-02 is performed over the next few years, it could potentially better link the theory to other areas of accounting theory.

Lastly, a comprehensive analysis on the effect of the new lease standards on companies' financial statements would offer accounting practitioners better understanding of the update. There has been some research conducted by large accounting firms showcasing how the lease standards practically affect the financial statements of firms once they finally adopt. However, considering the argument of whether or not the market is efficient, it would be interesting to see if the market is efficient enough to respond to the new information and adjust accordingly.

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AN ANALYSIS OF THE FINANCIAL REPORTING QUALITY OF EARLY ADOPTERS OF ACCOUNTING STANDARD UPDATE, ASU 2016-02

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