Lobbying with the FASB: The Case of Accounting For Pension Terminations and Curtailments(1)

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Abstract

A content analysis of the one hundred and ten letters received in response to Exposure Drafts for settlements and curtailments of defined benefit pension plans is combined with a comparison of the Exposure Drafts (FASB, 1986) and the final rule, SFAS 88, (FASB, 1988) to determine if lobbying efforts were successful in obtaining a more desirable rule.

Introduction

Many economic organizations in the United States engage in lobbying activities with the Financial Accounting Standards Board (FASB). This article is a case study of the effectiveness of one type of lobbying, written expressions of opinion in response to proposed new rules. The objective is to provide some evidence of FASB reaction to these lobbying efforts.

The most visible lobbying efforts are the written responses to Exposure Drafts (ED) of proposed new accounting rules. Typically, new accounting rules or major revisions of existing rules are first made public with the issuance of an ED. The EDs contain requests for written comment from interested parties and, frequently, state dates for public hearings. The written responses and, occasionally, the transcript of the public hearings are reproduced in the Public Record of the FASB.

A content analysis of the one hundred ten letters received in response to the ED for settlements and curtailments of defined benefit pension plans is combined with a comparison of the ED (FASB, 1986) and the final rule, SFAS 88, (FASB, 1988) to determine if the lobbying efforts were successful in obtaining a more desirable rule. The objective of our analysis is to increase managements’ understanding of the accounting rule-making process. Accounting choices have economic consequences for firms; therefore, it behooves management to be aware of their potential for determining available choices.

The first of the following five sections of this paper is a brief discussion of why one might choose to lobby with the FASB. The second section is an overview of the available evidence of FASB reaction to lobbying efforts, the third section describes the possible impact of adoption of the ED on firms and their financial statements, and the fourth section summarizes the lobbying positions of respondents and changes made in the ED. The last section is a discussion of the analysis presented in the fourth section and of the possible consequences of the decision to lobby with the FASB.

Why Lobby?

Actions of accounting regulators can affect the wealth of participants in economic activity in a number of ways. Potential tax reductions from accounting methods that result in lower taxable income provide the most obvious and direct economic consequences to firms, but there are a number of other ways in which firm and/or management wealth can be affected.
Management bonuses are frequently related to accounting income. Two accounting policy strategies may be used to maximize these bonuses. The most obvious strategy is to select or lobby for accounting methods that will result in higher levels of income. An income smoothing (minimizing the volatility of the accounting income time-series) strategy may be used in conjunction with methods that result in higher income levels. Healy (1985) found that many bonus plans are written with income ceilings and floors so that management is rewarded by exceeding the floor in poor years and shifting income to future years in extremely good years. Also, Lambert (1984) has proven that, in general, management bonuses are maximized with an income smoothing strategy.

Many elements of debt covenants are also stated in terms of accounting variables. For example, there may be a requirement that retained earnings be maintained at a certain level which would be easier achieved (if it is a problem) with accounting methods that result in higher income levels. Another common requirement is that a certain debt/equity ratio be maintained. Thus, both balance sheet and income statement effects of accounting methods can potentially have an impact on financial costs.

Many large firms or firms in industries closely scrutinized by government agencies may perceive high income levels to be undesirable because of potential political costs. These firms might benefit from accounting methods that yield lower accounting income and methods that yield a less volatile income time-series.

Most academics accept the evidence that the equity securities market is efficient and, from that, accounting methods do not affect securities prices in the absence of other economic consequences. However, there is growing evidence that a substantial segment of management behaves as if reported accounting numbers do affect security prices (See, for example, O’Keefe and Salomon, 1985). If management does, in fact, believe that accounting numbers can affect securities prices, then they obviously have a strong incentive to lobby for accounting methods that they believe will enhance and/or stabilize securities prices.

Public accounting firms also have incentives to lobby. Three motivations have been suggested in the literature: (1) Some firms specialize in particular industries and have a competitive advantage when certain methods are required (Puro, 1984); (2) Part of the service auditing firms provide is lobbying on behalf of their clients (Watts and Zimmerman, 1986); and (3) Large public accounting firms prefer tight, well specified rules that minimize managerial and auditor discretion. The more specific rules reduce auditor/client conflict and legal exposure for the auditors (Miller and Redding, 1986; Buckmaster, 1988). Organizations that do not have to apply a specific accounting rule, yet have a large group of customers that will be subject to the rule, may perceive costs (or benefits) arising from the adoption of the rule. For example, eleven percent of the responses to the ED analyzed in this paper were from insurance companies and banks. It is likely these organizations perceived that the proposal would, as written, make certain types of annuities they sell less marketable or, in the case of banks, more marketable.

Comments made by a managing director of Blyth, Eastman Paine Webber provide an example of this type of motivation for lobbying (Corporate Financing Week, 1982). Defeasances of corporate debt transactions were created in order to remove debt from the balance sheet when, in fact the liability continued to exist. Following an announcement by the FASB that this favorable accounting treatment would not be acceptable, the director speculated that defeasances of corporate debt would not be undertaken. He was upset because his firm had been working on a $300 million defeasance deal with a major oil company that would probably not occur now that the FASB had announced its intention to prohibit removing the debt from the balance sheet. He further anticipated that "a heavy lobbying effort" would be forthcoming.
Evidence of FASB Reaction to Lobbying

We know that, at times, the FASB has appeared to change its position in response to business and accounting firm pressure. For example, after several years of strong opposition to its original rule on accounting for foreign operations (SFAS 8), the FASB replaced SFAS 8 with SFAS 52, a rule much less objectionable to management. However, there has been little investigation of the relationship between the participation of interested groups in FASB due process and final FASB rules.

Haring (1979) examined the relationship of the positions of large audit firms and large audit clients to the FASB’s final position on eight of the early FASB projects (pre-1977). His objective was to test the idea that the FASB was dominated indirectly by large business firms through their influence on the large accounting firms. The dual hypotheses were that (1) the large accounting firms lobbied on behalf of their clients, and (2) the FASB would adopt the preferences of the large accounting firms. Haring’s tests suggested that the FASB was influenced by the large accounting firms; but, surprisingly, FASB final positions were inversely related to the preferences of large business firms.

Brown (1981) examined the responses of frequent lobbyists to the Discussion Memorandums for the first nineteen SFAS’s (pre-1980) to determine the degree of FASB alignment with the lobbyist preferences. Brown found that preparer preferences and auditor preferences formed two natural classifications. The FASB final rules were not consistently close to preparer or auditor positions.

Francis (1988) examined the responses to a 1985 document expressing FASB views on what ultimately became SFAS 87, the current rule for accounting for pensions. His primary objective was to study the determinants of who lobbies; however, he notes that the respondents were generally opposed to the proposed requirements that projected future salaries be used for estimating pension benefits and the procedures for amortizing actuarial gains or losses. The projected future salaries requirement was dropped and the amortization procedures revised so that most of the potentially adverse balance sheet and income statement effects were eliminated.

Allen and Buckmaster (1986) prepared an analysis of the responses to an ED proposing new accounting procedures for accounting for interest rate futures contracts and forward and standby contracts. This analysis was a case study using methods very similar to those used in this paper. However, the outcome was quite different. While CPA firms and governmental units tended to support the proposal, most banking and other industry respondents (seventy-four percent of the respondents) opposed the ED. The FASB backed away from the ED and, instead, issued a Technical Bulletin that described the application of an existing rule.

The four studies just described constitute the published studies of the relationship between lobbying and FASB rules. Obviously the evidence is too sparse to provide any definitive answers to questions of current FASB responsiveness to lobbying. However, there is the suggestion that, on average, the FASB does not alter its position to accommodate any specific interest group, but occasionally a proposal will be changed in response to opposition contained in constituent responses.

The Proposed Rule and Its Consequences

The rules toward which the reported lobbying efforts were directed concern accounting for terminations and curtailments of defined benefit pension plans. The central issues are the timing of gains and losses from these activities and what should be disclosed in financial statements about the financial effects of terminations and curtailments. The ED would require that a gain or loss be recognized in the year when a defined benefit pension plan was terminated or curtailed. Also, the termination or curtailment would be described and the amount of the gain or loss would be explicitly disclosed. If the ED were rejected, then the most likely accounting treat-
ment accorded pension settlements and curtailments would be that required by SFAS 87 (FASB, 1985A), the rule for accounting for pensions. Immediate recognition of termination or curtailment gains and losses would not be required by SFAS 87. Rather, these gains and losses would be amortized over several future periods. The practical results in most cases of immediate gain or loss recognition as required by the ED (and subsequently, SFAS 88) rather than amortization of these gains or losses as would be required by SFAS 87 is the introduction of greater volatility into the income time-series. This assumes that management is unwilling to let accounting results dictate the timing of pension settlements and curtailments.

If management is willing to bear the potentially high cost of letting accounting rules dictate timing of pension terminations and curtailments, then immediate recognition of gains and losses can be used to minimize income volatility. All that is necessary is to implement a termination or curtailment with a net gain in a year with lower accounting profits than desirable and vice versa. But it is quite likely that the non-accounting economic costs from an accounting-dominated policy will substantially exceed the benefits from such a policy.

Who Lobbied?

Table 1 provides a breakdown by organization type of the lobbying organizations. Seven representational organizations such as the Financial Executives Institute are included in the industry classification(4) and seven representational organizations such as the New Jersey Society of Certified Public Accountants are in the Public Accounting classification. The Robert Morris Associates and the American Academy of Actuaries also submitted position papers on the ED and are classified in the Banking and Actuaries classifications respectively.

We have indicated the likely motivations to lobby for industrial firms, auditors, insurance companies, and banks. Letters from law firms are rare. We suspect that the law firms have important clients that will be adversely affected by the proposal. A careful reading of letters from law firms does nothing to dispute this supposition.

Elements of the ED, Lobbying Positions, and Changes In the ED

Exposure Drafts and Statements of Financial Standards are written such that each numbered paragraph usually contains an element of the proposal or rule upon which a respondent can focus if he chooses. The subsections of this part of the paper (1) identify the nature of the content of each of the fourteen paragraphs that were likely to attract some comment from the lobbyists; (2) indicate the support / oppose positions of

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<thead>
<tr>
<th>Organizational Class</th>
<th># of Respondee</th>
<th>% of Total</th>
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<tbody>
<tr>
<td>Law</td>
<td>2</td>
<td>1.8%</td>
</tr>
<tr>
<td>Insurance</td>
<td>2</td>
<td>1.8%</td>
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<tr>
<td>Actuaries</td>
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<td>5.4%</td>
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<td>Banking</td>
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<td>68.2%</td>
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<tr>
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Table 1
Respondents By Organizational Class
the lobbyists; and (3) briefly describe how the corresponding section of the SFAS differs from the ED. Table 2 contains a count of the lobbying positions for each paragraph and the change made in the ED is identified as substantive (yes) or as minor or no change (No). Also, the final column indicates if the wording of SFAS 88 was made more specific or more detail was added.

Paragraph 2 indicates the scope of the ED and is identical to paragraph 2 of SFAS 88. It attracted little attention (one support and five oppose).

Paragraph 3 defines "a settlement." If the number of respondents commenting on an element is a measure, then this is a key part of the ED. This paragraph elicited eleven support comments and twenty-one negative comments. The changes that were made in this paragraph have the potential to affect the accounting treatment of some set of transactions. The ED definition is in terms of how a settlement is made and the SFAS 88 definition is in terms of disposition of risk by employers. The revised definition will make it easier to avoid coming within the definition of termination; but in order to avoid coming within the scope of the ED, management may have to change the economics of the transaction.

Paragraph 4 defines an "annuity contract" and is revised for the SFAS so that it will be consistent with SFAS 88, paragraph 3. That is, for those annuity contracts where risk is retained by the annuity purchaser, the transaction is not a settlement. This section attracted only moderate attention (five support/eight oppose).

Paragraph 5 defines a curtailment and is not controversial (one support/one oppose). Minor wording changes were made that have no practical effect on the implementation of the rule.

Paragraph 6 describes annuity contract purchases that will be subject to the proposed rule. Despite the minimal attention given this section of the ED (one supporting and one opposed), the addition in SFAS 88 of the word "non-participating" to the description of annuity contract purchases that constitute a settlement was a substantive change in that it puts more potential transactions outside the scope of the rule. Overall, the changes made to paragraphs 3, 4, and 6 permit

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<th>Paragraph</th>
<th>Industry</th>
<th>Public Accounting</th>
<th>Actuaries</th>
<th>Insurance Cos., Banks, and Lawyers</th>
<th>Total</th>
<th>Substance Accounting or Transaction Coverage</th>
<th>More Specific or Added Detail</th>
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<td>2</td>
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</table>

| Totally support or oppose | 11 | 8 | 1 | 3 | 4 | 16 | 11 |
| Detail or clarification requested | 16 | 1 | 7 | 1 | 2 | 1 | 24 | 4 |

3 = support
0 = oppose
management more latitude in structuring transactions so that they are outside the scope of SFAS 88. However, there may be significant costs to achieving the structuring goals since management will be forced to retain or share the risks associated with relevant actuarial assumptions.

It is unclear to what degree those lobbyists seeking to retain decision flexibility were able to obtain their objectives. However, the FASB almost certainly reacted to respondent letters in making "risk shifting" a primary criterion for a substantial portion of transactions covered by SFAS 88. Several respondents wrote rather eloquent letters identifying risk as the distinguishing characteristic of terminations.(5)

Paragraph 7 sets forth the conditions that determine the treatment of gains or losses from pension terminations. Thus it is a key element of the ED and drew much attention from the respondents (six support and twenty-three oppose). The most important change in ED paragraph 7 was made necessary by the changes in the preceding definitional paragraphs. Changes in earlier paragraphs induced the addition of a description of the treatment of the cost of a participation rights when the participating annuity qualifies as a settlement. Other changes in paragraph 7 provide a more specific description of the measurement procedures, alter the materiality criterion, and add a consistency criterion. Despite the opposition, the FASB did not substantively alter the substantive requirements of paragraph 7.

Paragraph 8 specifies the treatment of gains and losses from pension curtailments. Like paragraph 7, it is a key element that attracted considerable attention from the respondents (thirteen support and twenty-three oppose). The substantive change in paragraph 8 is that different criteria for recognizing curtailment gains and losses are specified in SFAS 88. Net curtailment losses are to be recognized when they can be reasonably estimated; whereas, curtailment gains are not to be recognized until the affected employees are terminated or the curtailment actually goes into effect. This change does not add anything to management flexibility or accounting income stability. Rather, the change merely incorporates traditional "accounting conservation" into SFAS 88. There are other changes in paragraph 8 that make SFAS 88 more specific in describing the measurement procedures and another example is added in the SFAS. But, in summary, the outcome is the same as with the preceding paragraph in that the FASB did not react to opposition to the requirement.

Paragraph 9 requires that special termination plans that are contingent upon the occurrence of some possible event be recognized as a liability and loss when employees accept the plan. It is another key element of the ED with five respondents supporting the rule and twenty-one opposing it. The opposition was at least partially successful in that the FASB altered the recognition event to "when it becomes probable that the employees will be entitled to the benefits and the benefits can be reasonably estimated." This is, of course, the general accounting rule for loss contingencies.

Paragraph 10 is a statement that the ED supersedes SFAS 74, the rule previously issued for special termination benefits. This paragraph is of no interest drawing only one opposing comment and there was no change.

Paragraph 11 prohibits gains and losses recognized as a result of application of the ED from being recognized as "extraordinary." The prohibition drew a moderate amount of opposition (one support and eight oppose), but there was no substantive change.

Paragraph 12 contains the disclosure provisions of the ED. There was only nominal comment (one support and two oppose) on this paragraph and there were no substantive changes in the disclosure requirements.

Paragraph 13 deals with the date of initial application of the proposed rule and prohibits the restatement of prior period statements upon adoption. This paragraph may surprise many by the attention it attracted (three support and
eleven oppose), but respondents frequently lobby for greater implementation periods. A statement was added in the SFAS that specified the treatment of relevant events in the interim statements in the year the rule is adopted. This was a substantive change that also provided clarification; but was not the change that most respondents desired.

Paragraph 14 contains another important accounting measurement provision. This section requires that unamortized, unrecognized gains from asset reversion transactions prior to the implementation of the proposed rule be recognized as a gain when the rule is implemented. The paragraph was the subject of twenty-eight comments (twelve support and sixteen oppose), all from industry. Given the relatively high proportion of support comments and that the required treatment is consistent with the conventional treatment of the effects of a change in accounting principle, it would be surprising if this section were changed. There was no surprise.

Paragraph 15 indicates that unrecognized gains and assets arising prior to application of the SFAS 87, the primary pension accounting rule, shall not be recognized immediately. The addition contained in SFAS 88 extends the coverage to unrecognized losses and liabilities at the date of application of SFAS 87. Although the addition may reduce the flexibility of management, it is probably the only favorable accounting method accommodation in the ED changes. The requirement permits recognition of unrecognized losses and liabilities over a number of years, thereby minimizing negative effects on financial statements and the volatility of the firm’s income time-series.

It is obvious that those lobbying against the accounting rules proposed in the ED had rather limited success when we compare the ED, SFAS 88, and the concentrations of lobbying effort. Even though there was one change in the rules that might favor management, the substance of the proposed rules remains in SFAS 88 and SFAS 88 is even more restrictive than the ED.

On the other hand, the FASB appears to have at least partially accommodated that twenty-three percent of the lobbyists that requested clarification of sections of the ED or more detail. Nine of the fifteen paragraphs of the proposal were made more specific and/or expanded by adding more examples. Also, an example of accounting for a plan termination without a replacement defined benefit plan was added to the appendix of illustrations of application of the rules.

Discussion

The written comments of those responding to a FASB ED are compared with the changes made in arriving at the final rule, SFAS No. 88. Lobbying efforts did not result in significant changes in the accounting or disclosure rules. Those desiring more specific rules and more examples of application probably influenced the FASB since SFAS 88 was a much more tightly constructed, specifically-stated document, with additional examples of how to apply the rules. In this case, it appears that the FASB carefully considered the written responses and utilized them in clarifying difficult issues and closing loop-holes.

Keep in mind that this is a case study and we cannot validly generalize from this sample of one. Despite this, we believe that the FASB reaction to the written comments is typical of most of the issues they address. The number of letters received in this case is probably close to the median number received on all issues which suggests this issue affects a limited number of organizations and is only moderately controversial.

One aspect of the lobbying positions that is not typical for other issues we have examined is that there is an unusually large number of respondents that support the proposal. Supporting letters have been rare in other cases we have examined. This unusual support for this proposal may have been a factor that minimized substantive change in the ED by the FASB. Evidence from additional studies are necessary to resolve this issue.
Obviously, the analysis in this paper does not provide an answer to the question of whether one should lobby with the FASB or not. The focus of this paper has been on lobbying support and opposition and changes made to the final rule. Thus the variable of concern is the possibility of influencing the outcome through responding to an Exposure Draft. But variables other than probability of influence should be considered.

Consider first the nature of any decision to lobby on issues of significance to the firm that are raised by the FASB. Such a decision requires (a) systematic monitoring of FASB activity; (2) analysis of the impact of FASB proposals on the firm; (3) development of the lobbying strategies for issues of significance, and (4) carrying out the lobbying strategies. Thus most lobbying costs are probably fixed costs. Consider now some of the benefits from lobbying with the FASB. First, firms should avoid being surprised about the impact of new FASB rules on the firm. The systematic monitoring of FASB activities and analysis of the impact of FASB proposals on the firm will provide the information necessary to minimize the impact of new accounting rules on firm activities. Similarly, if an issue affects firm accounting, then sooner or later the firm must implement the rule. Implementation costs may be reduced by the earlier knowledge provided by monitoring activities. If the decision to monitor and analyze FASB activities is made, it will probably be possible to extend with little incremental cost such activities to the SEC and other regulatory agencies that affect accounting activities of the firm. Conversely, if the firm is already monitoring new regulations by the SEC and other regulatory agencies, it might be possible to utilize that mechanism to monitor and analyze FASB activity with little additional cost.

The smaller listed firms probably will not find it cost efficient to lobby, particularly if they are not widely diversified. Not only does the potential benefit relative to lobbying cost appear to be a function of size, many of the issues considered by the FASB will not affect these firms. However, as firm size increases and becomes more diversified, the lobbying decision becomes more important.

Our statements about the decision to lobby by auditor clients can be extended to the public accounting firms as well. There seems little reason for small CPA firms with few or no audit clients to establish the mechanism for lobbying. As the number of audit clients of CPA firms increases, so do the potential benefits from lobbying. Of particular concern to auditors is the precision and clarity with which rules are written. The more precise rules will minimize auditor-client conflict and reduce auditor legal exposure.

Finally, we would be remiss if we fail to mention that officially responding to exposure drafts is only one of a number of methods that accounting firms and other business firms use to lobby for accounting rules. For example, organizations frequently have employees that serve on the governing board of the FASB, serve on task forces that do a great deal of the preliminary work for the FASB, and meet with the FASB members informally.

Endnotes

1 This research was partially supported by a grant from the Advanced Accounting Education Fund, Department of Accounting, University of Delaware.


3 For reviews of this literature, see Kelly (1983) or Watts and Zimmerman (1986).

4 The National Association of Accountants is
classified as "Public Accountants" in the Public Record. However, most members are employed in industry and are not engaged in the practice of public accounting. An "industry" classification is more appropriate for this organization.

5 An example is the letter from Daniel B. Stone, a tax and pension lawyer with the Washington firm of Ivins, Phillips, and Barker.

References

4. "FASB Turns Thumbs Down on Taxable Deferrals" Corporate Financing Week, August 9, 1982.