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Disclosure versus recognition: Evidence from lobbying behavior in response to SFAS No. 158

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ABSTRACT

This study examines the lobbying behavior of firms following the release of the SFAS No. 158 exposure draft. SFAS No. 158 requires the recognition of previously disclosed net pension and postretirement benefit obligations on the balance sheet. The study documents that firms that lobbied against the pronouncement had large, underfunded plans and the decision to lobby was related to the magnitude of the SFAS No. 158 balance sheet adjustment. The findings have important implications for the recognition versus disclosure debate because they document management's reaction to the relocation of information disclosed in the financial statement footnotes to its recognition on the balance sheet.

Introduction

SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, moves disclosures of defined benefit pension plans and other postretirement (primarily health and life insurance) benefit (OPEB) plans from the footnotes to the balance sheet (FASB, 2006). The measurement of pension and OPEB obligations remains unaltered. However, firms must recognize the funded status of these postretirement benefit[2] plans on the balance sheet.

A number of studies have examined the characteristics of firms that undertook lobbying efforts in response to various changes in reporting and disclosure requirements. In a setting similar to the present one, Francis (1987) examined the lobbying efforts of firms who opposed the provisions that led to SFAS No. 87, Employers' Accounting for Pensions and showed that "both firm size and the potential for adverse financial statement consequences explain the decision to lobby."

This study extends the Francis (1987) analysis to the lobbying efforts following the release of the SFAS No. 158 exposure draft (ED). However, there is one important difference between the SFAS No. 87 and SFAS No. 158 environments. SFAS No. 87 changed and standardized how pension assets/liabilities were to be calculated and reported (FASB, 1985). SFAS No. 158, on the other hand, does not change any of the calculations; it just requires recognition of items previously disclosed.

The Francis (1987) study is similar to Deakin (1989) and Ramanna (2008) in that these papers investigate lobbying behavior related to proposed changes in the accounting for recognized items. Deakin (1989) examines the characteristics of companies that lobbied in response to the change proposed in the 1970s from Full Cost to Successful Efforts reporting, while Ramanna (2008) examines lobbying related to changes in goodwill reporting.

Other studies have examined lobbying behavior related to proposed disclosure or reporting of previously undisclosed items. Lo (2003) examined lobbying efforts against requiring previously undisclosed executive compensation to be newly disclosed. Dechow, Hutton, and Sloan (1996) examined the debate surrounding SFAS No. 123 relating to requiring recognition or disclosure of previously undisclosed stock based compensation.

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[2] The term postretirement benefit plans encompasses both defined benefit pension plans as well as other postretirement (health and life insurance) plans.

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This study extends the previous research by examining lobbying behavior in the setting of SFAS No. 158. As noted, this setting differs from those mentioned above insofar as the item in question – the funded status of postretirement plans – was already disclosed. SFAS No. 158 simply moved the disclosure of these amounts from the financial statement footnotes to the face of the balance sheet. Whether firms lobby against a disclosure-to-reporting requirement is an empirical question of interest to regulators and academics interested in the area of lobbying behavior.

In extending the research regarding lobbying behavior, this study also provides insight into the disclosure versus recognition debate, in terms of management's perception. There are a number of empirical studies that have documented a significant difference in the market's valuation of recognized versus disclosed items. In the oil and gas industry, Aboody (1996) found that the recognized write downs of full cost firms were given greater weight by the market than the footnote disclosures of successful effort firms. Ahmed, Kilic, and Lobo (2006) found that post-SFAS No. 133 recognized derivatives are valued by the market whereas pre-SFAS No. 133 disclosed derivatives are not. More pertinent to the subject matter of this study, Davis-Friday, Liu, and Mittelstaedt (2004) found that the market treats disclosed information concerning OPEB obligations as less reliable than recognized information. These studies all conclude that the market does not view disclosure as a substitute for recognition.

Bernard and Schipper (1994) posit that, in general recognized items are viewed as more reliable than disclosed items, by virtue of their recognition alone. Under the FASB's conceptual framework, to be recognized an item must be measurable and reliable, criteria that need not be met for disclosed items. Thus investors perceive recognized items as inherently more reliable than disclosed items. On the other hand, Holthausen and Watts (2001), argue that recognition may lead to less reliability. They argue that managers have more incentive to manipulate recognized items relative to disclosed items.

Studying management lobbying behavior in response to the SFAS No. 158 requirement to recognize previously disclosed items provides a unique setting to capture management's perspective on the disclosure versus recognition question. Finding that firms that lobbied against the pronouncement had large, underfunded plans and that the decision to lobby was related to the magnitude of the SFAS No. 158 balance sheet adjustment are consistent with the notion that managers do not view disclosure as a substitute for recognition.

Hypotheses

Following the release of the SFAS No. 158 ED, the FASB invited the public to submit comment letters on the proposed reporting requirement. The new proposal required firms with underfunded plans to adjust their balance sheets to reflect the full underfunded status of their plans. One would expect managers of firms that would be adversely affected by the rule change to lobby against the new proposal as recognition could potentially have negative effects on their debt covenant agreements and introduce volatility into the balance sheet. Thus I expect that the more underfunded the plans, the more likely firms will be motivated to lobby against the provisions of the ED. Formally, this leads to the following hypothesis:

Hypothesis 1a. The more the firm's pension and postretirement plans are underfunded, the higher the likelihood that the firm lobbied against the implementation of SFAS No. 158.

It can, however, be argued that it is not the funded status itself that is of relevance but rather the mandated balance sheet adjustment that is crucial. The SFAS No. 158 adjustment reflects the difference between the firm's funded status and the amount already reported on the balance sheet. These differences are due to the smoothing provisions of pension accounting. Under GAAP, actual increases or decreases in pension assets and the projected benefit obligation (PBO) are not reported on the financial statements as they occur. Actual investment gains/losses of pension assets are smoothed by using an expected long-term rate of return. Similarly, changes in the PBO resulting from changes in actuarial assumptions (such as discount rates, rate of compensation increase, mortality and quit rates) are amortized over time. The rationale behind this is to remove volatile (external) market fluctuations from the firm's income statement and balance sheet.

These differences would not be expected to be uniform across firms. Although firms generally face similar market conditions, the impact on the actual return on assets would depend on the make-up of firms' investment portfolios (equity versus fixed income; US versus international). Moreover, the gap between the actual and recognized gains/losses would depend on the assumed expected rate of return. Firms that had expected rates of return on assets that were too 'high' ('low') would have larger unrecognized losses (gains) in comparison to those that used more 'moderate' expected rates of return on assets.

Additionally, changes in actuarial assumptions such as mortality and resignation rates would vary by firm depending to a great degree on the age and education of the work force. Similarly, effects of and changes in the discount rate or the rate of compensation increase would depend to some extent on initial assumptions made by firms and on the age of the work force (i.e. duration of the liability).[3]

These myriad factors would certainly play a large role in the size of any firm's SFAS No. 158 adjustment. Firms that had already, prior to the ED, substantially recognized the funded status of their plans would not be affected by the new proposal. To the extent that the funded status had already been recognized it would lessen any incentives to lobby against the ED. On the other hand, the greater the unrecognized portion, the more likely managers would lobby against the ED. This leads to the refinement of the above hypothesis:

[3] The smoothing of unrecognized prior service costs and the minimum liability adjustment (where applicable) can also affect the difference between the reported and funded status. For the sake of conciseness, I have limited my discussion to the more pervasive factors of actuarial and investment gains/losses.