ACCOUNTING STANDARDS FROM AN ECONOMIST'S PERSPECTIVE *

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SEC Commissioner Cox examines the differences between accounting and economic viewpoints in two specific areas: measurement or valuation of transactions and location of disclosure in financial statements.

First, Cox examines measurement problems, using accounting for junior stock and contingent customer warrants as examples. Both have economic value when issued, but accounting treatment results in incomplete recognition of this value. Systematic research should be done to explain and possibly eliminate this disparity.

Second, Cox discusses the relevance of location of disclosure, using accounting for in-substance defeasance of debt and reversion of pension plan assets as examples. Although location of disclosure would be irrelevant in an efficient market, it is in fact a major issue for many companies. Their noneconomic concerns should not be addressed indirectly through changes in financial reporting.

Cox believes that accounting treatment should, in many cases, more closely reflect the economics of business transactions. Efforts to reconcile the two, even if not ultimately successful, will provide useful information about the nature and purpose of the differences.

1. Introduction

As the title of this conference indicates, we are here to consider the SEC's participation in accounting during the past fifty years as well as possible future trends. As an economist and a Commissioner reviewing some accounting issues during the past year, I would like to raise questions about some accounting treatments that have developed with the participation of the SEC. I will concentrate on applications of accounting rules to new business practices.

Interaction between accounting and economics is to be expected. Accountants and economists share some fundamental concerns. Both professions are interested in clear, useful, and reliable quantified descriptions of economic realities.

* The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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Nevertheless, I recognize that accounting is not economics, nor should it be. There are numerous differences between the two, such as the distinction between accounting and economic profits. Because of the differences in our professions, it is not surprising that, during my tenure as a Commissioner, I have encountered several accounting treatments that are contrary to my perspective as an economist. Some of these treatments have resulted in nonrecognition or incomplete recognition of economic events in public companies' financial statements. In some cases, substantial resources have been invested in order to influence the determination of whether an event should be reported in the financial statements or in the notes to those statements. An economist who accepts the efficient market hypothesis expects the market to reflect the event regardless of where disclosure occurs.

In this article I will discuss these two subjects. In analyzing instances in which accounting does not reflect an economic event—in accountants' terms, instances in which accountants perceived that the lack of reliable measures outweighs the relevance of the events to be measured—I will concentrate on the examples of junior stock and contingent stock purchase warrants. In discussing issues in which the debate has centered on the means by which disclosure should be made, I will focus on the examples of in-substance defeasance and of reversion of excess pension plan assets to a corporation after a restructuring of its pension plan.

In this discussion I wish to raise two sets of questions. First, when accounting does not reflect economic reality, can more be done to see whether there are reliable means to measure that reality? Have there been developments in economics and finance that can be used to solve the problem? Second, when the debate centers on whether disclosure should be in the financial statements or the notes, to what extent does it matter? Are some parties motivated by interests that have little to do with the integrity of the financial statements, or the accuracy of the accounting, and its usefulness for predicting a company's future trends?

2. Relevance and reliability

I will first address the balance that accountants strike between describing economic reality and using only trustworthy measures of that reality—between what accountants call relevance and reliability.

As a starting point, I agree with the recognition of the balance in the Financial Accounting Standards Board's Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information [1]. As explained in that Statement:

Although financial information must be both relevant and reliable to be useful, information may possess both characteristics to varying degrees. It may be possible to trade relevance
In determining the optimal trade-off, however, an economist's opinion may differ from that prevalent among accountants. Let me explore this balance with two issues that the SEC has faced since I became a Commissioner: junior stock and contingent stock purchase warrants.

2.1. Junior stock

Accounting for junior stock – a means used by some high-technology companies to afford officers and other key employees a stake in the company's future – is an example of application of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees [3]. Because the FASB last May issued an Invitation to Comment on the subject of APB 25, I hope that my discussion will suggest some systematic studies relevant to accounting for these compensation plans.

An economic event occurs when a company issues junior stock. The employees receive a special class of stock that is convertible into regular common stock of the issuing corporation. Under a typical junior stock plan, this special class of stock carries reduced or no voting or dividend rights. The employee's ability to sell the shares is restricted. On the other hand, the stock becomes convertible into regular common stock upon the achievement of specified corporate operating results. From an economist's perspective, when junior stock is issued, it has a value that depends primarily on the likelihood that the conversion conditions will be met and on the anticipated value of the regular common stock at whatever time those conditions are expected to be met.

The original treatment of junior stock by the Commission staff fits this economist's perspective. Junior stock first came to the staff's attention in 1981, when a public company [4] sought to treat its junior stock as a separate class of stock because in the company's view the likelihood of achieving the conversion conditions was remote.

The company argued that its junior stock was not subject to APB 25, which indicates that compensation cost should be determined when the ratio of conversion is known (unless other terms remain variable). Moreover, the company asserted that its employees paid the fair value of the junior stock when they received it. According to the company's view, if the value of the stock increased because the conversion conditions were met, no compensation would have to be recognized because the employees invested in the company and paid the proper price for their investment. In 1981, the SEC's staff did not object to this view.

As junior stock plans proliferated, with conversion virtually assured in some
cases, the SEC staff reconsidered the issue and asked the FASB whether it wanted to address the subject. In August 1984, the FASB issued Interpretation No. 38 [5], which provides that APB 25 applies to junior stock plans. Compensation is not determined when the employee purchases the junior stock. Rather, it is determined when the number of shares of regular common stock which an employee is entitled to receive in exchange for the junior stock is known.

I do not object to the FASB's interpretation of APB 25. I have reservations, however, about what the rule ought to be. As I have said, an economic event occurs when an employee purchases junior stock. It seems to me that the value of that stock probably depends not so much on that employee's performance as on factors generally beyond the employee's control, factors such as general economic conditions, industry growth, and other employees' performances. Consequently, if the economic event is not to be fully recognized at the time it occurs, the justification is likely to be a lack of a reliable way to measure the value of the junior stock. In the analyses brought to my attention while the issue was pending during this past year, I saw little systematic study of the reliability of measures of the value of junior stock. Since the measures employed so far have been appraisals by investment bankers, such study might concentrate on the appraisal techniques used or on a search for alternatives. I would suggest that some such systematic study by academic accountants would be helpful in deciding the accounting treatment of junior stock.

2.2. Contingent stock purchase warrants

My second example is contingent stock purchase warrants. In connection with sales agreements, a public company [6] issued contingent warrants to some major customers to purchase shares of its common stock at prices twelve to fifteen percent in excess of the current trading price of the stock. These warrants became exercisable only if the customer purchased specified amounts of the company's products within a specified period of time. Thus, major customers received the opportunity to benefit from appreciation in the price of the company's stock.

The company believed it could account for the transaction based on APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants [7]. In consultation with an investment banker, the company valued the shares represented by the contingent warrants at the date the sales agreements were executed. It then amortized this amount as sales discounts as products were sold.

The SEC's accounting staff disagreed. In Staff Accounting Bulletin No. 57 [8], the staff noted that whether the customer purchases sufficient products to become entitled to acquire shares depends on various factors. These variables include the issuer's ability to deliver products, the customer's need for the
products, and, possibly, the market price of the issuer's stock during the term of the contingent warrants. The staff stated:

Valuation of the contingent warrant shares prior to resolution of these uncertainties would not provide an appropriate measurement of the cost to [the] [c]ompany ... of the inducement to the customers to enter into the sales agreement [9].

The staff further stated that, at the time the sales agreements are executed, it cannot even be determined whether there is a cost to the company from the contingent warrants [10].

The staff concluded that the cost must be measured on the date the warrants become exercisable. The cost then is the difference between the market price of the company's stock at that date and the amount the customer is required to pay. Prior to that date, the company must periodically determine whether it is probable that the customers will make purchases sufficient to render the warrants exercisable. Sales made after a determination that sufficient purchases are probable are to be charged with a pro rata allocation of the estimated ultimate cost of the warrants.

In a footnote to SAB 57, the staff said it considers its treatment of contingent warrants to be analogous to treatment under APB 25 of certain securities issued to employees. The staff added that it will consider the issue again after the FASB completes its project to reconsider APB 25 [11].

Again, I do not object to the staff's interpretation of existing accounting principles and rules. However, I do have reservations about what the rule should be. From my perspective as an economist, a contingent warrant has value. If that value is not to be recognized at the time the contingent warrant is issued, it seems to me that the explanation should be that there is not a sufficiently reliable means to measure that value. Once again I see an opportunity for academic accountants to enlighten those who make accounting rules by undertaking systematic studies of the reliability of measures of the value of contingent rights to obtain stock.

2.3. Remarks on relevance and reliability

I would like to conclude my remarks on relevance and reliability by discussing conservatism in the sense that accountants use the term. It may sound ironic to hear this from a member of the Chicago school of economics, but my professional orientation is different from your profession's historical inclination toward conservatism. I find it easy to agree with the following views expressed in FASB Concept Statement No. 2:

Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits.
Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred [12].

Although I agree with these statements, I expect that analysis would show that adequate evidence of some economic events exists where accountants think it is lacking. I realize that Concept Statement No. 2 also says, "almost everyone agrees that criteria for formally recognizing elements in financial statements call for a minimum level or threshold of reliability of measurement that should be higher than is usually considered necessary for disclosing information outside financial statements" [13]. Nevertheless, some techniques from finance and economics might well provide a basis for developing appropriately reliable measures. One such technique that merits analysis for possible adaptation to measure the value of junior stock and other contingent rights to obtain stock is the Black–Scholes option pricing model, which has gained broad acceptance in the options industry. At the least, if investment bankers' appraisals of junior stock or other contingent rights to buy stock do not meet the minimum threshold of reliability, it would be helpful to have a reasoned explanation of why they do not. Similar explanations probably would also be helpful when available measures of other economic events are considered so unreliable that the accounting rules must be written to prohibit the use of those measures. In saying this, I am not endorsing or rejecting appraisals or other measurements. I am only pointing out that a systematic study of them seems wise before they are deemed so unreliable that they cannot be used in preparing financial statements.

3. Location of disclosure

My second general topic is debates over whether disclosure should occur in the financial statements or in the footnotes. Again I will begin by generally agreeing with the views of the FASB expressed in the Exposure Draft of the Proposed Statement of Financial Accounting Concepts on Recognition and Measurement in Financial Statements of Business Enterprises [14]. As stated there: "[D]isclosing information parenthetically on the face of a financial statement or in notes is not recognition. Notes and other means of financial reporting are available and useful, but they are not a substitute for recognition in financial statements" [15]. The idea of preserving the integrity of the financial statements by maintaining standards for when disclosure must be in the financial statements themselves, rather than in the notes, is appealing. Indeed, the Commission has long taken the position that disclosure in footnotes is not a substitute for disclosure in the financial statements. In Accounting Series Release No. 4 [16], for example, the Commission stated its policy
that financial statements prepared in accordance with accounting practices for which there was no substantial authoritative support were presumed to be misleading and that footnote or other disclosure would not avoid this presumption.

Nevertheless, from the perspective of an economist, whether disclosure occurs in the financial statements or in the footnotes seems unlikely to have much effect on the market price of a company's stock. This conclusion follows from accepting the efficient market hypothesis—that is, the hypothesis that the market efficiently absorbs information and, therefore, reflects that information in market prices. This is not to suggest that every small investor processes all available information. It appears to be the case, however, that there are enough professionals in the market that, if the market price for the securities of a public company does not reflect the available information, the professionals will quickly see an opportunity and trade to take advantage of it until the price does reflect the information.

If an effect on market prices does not explain public companies' expenditure of resources to influence where disclosure is made, what does? I have heard suggestions of at least four possibilities: cosmetic effects, tax effects, avoidance of problems with covenants related to the corporation's bonds or other debt, and maximizing returns to managers under incentive plans. Another possibility is that public corporations do not accept the efficient market hypothesis and think that they can influence the prices of their securities by controlling where disclosures are made.

With the efficient market hypothesis in mind, I would like now to examine two examples of what is to an economist the interesting phenomenon of public companies expending substantial resources in order to influence whether disclosure is to be in the financial statements or in footnotes. These examples are in-substance defeasance and reversion of excess pension plan assets after restructuring of the pension plan.

3.1. In-substance defeasance

In August 1982, the SEC issued an interpretative release [17] on accounting for extinguishment of debt with so-called "quasi-defeasance" or "in-substance defeasance" arrangements. In essence, these arrangements involve transactions in which assets are dedicated to the future servicing and repayment of currently outstanding debt. The debt is then accounted for as extinguished even if it is not legally satisfied and related liens are not released. The Commission required public companies to follow what was then the FASB's tentative decision that debt should not be accounted for as extinguished unless the debtor has no further legal obligation [18]. The FASB continued to study the issue.

In November 1983, the FASB adopted Statement of Financial Accounting
Standards No. 76, Extinguishment of Debt [19], by a four to three vote of the members of the Board. This Statement provides for treating debt as extinguished if two conditions are met. First, the debtor must irrevocably place cash or other essentially risk-free assets in a trust to be used solely to satisfy the debt. Second, the possibility that the debtor will be required to make future payments with respect to the debt must be remote. The only assets other than cash that the FASB defines as essentially risk-free are, in essence, government securities.

The FASB’s Statement also requires that the footnotes to the financial statements disclose a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as the debt remains outstanding [20].

In December 1983, the Commission voted to rescind the moratorium on in-substance defeasance that had been imposed by Financial Reporting Release No. 3 while the FASB studied the issue [21]. Although the release rescinding Financial Reporting Release No. 3 contained some discussion of the qualifications of the trustee and the nature of the assets in the trust, the Commission in essence supported the views adopted by the FASB.

On October 17, 1984, the FASB published a Technical Bulletin on instantaneous in-substance defeasance. The Technical Bulletin states that debt may not be extinguished through in-substance defeasance if the assets that the debtor irrevocably places in trust were acquired at about the time the debt was incurred.

Neither the FASB’s Statement from November 1983 nor the Commission’s releases discuss public companies’ motivations for in substance defeasance. From an economist’s perspective, it appears unlikely that the motivation is merely the benefit to be gained from a difference between the interest rate the company obligated itself to pay when it issued the debt and the interest rate now available from the assets that the company would purchase in order to dedicate them to extinguish the debt. If the purchase of government securities is the company’s best economic opportunity, I would expect the company to choose that opportunity regardless of whether the accounting for it appears in the financial statements or in the footnotes. Hence, it would appear that some extraneous factor, such as the tax system imposed by the government or a bond covenant that now poses difficulties for the company, is influencing how the company wants to report its economic condition.

3.2. Restructuring of pension plans

My second example of companies’ concern about where to make disclosure is the accounting treatment for reversion of excess pension plan assets to a public company [22] that restructured its pension plan for salaried employees. In effect, the company determined that its existing plan, a defined benefit plan,
contained more funds than necessary and decided to restructure its plan in order to use part of the funds to cover existing obligations and to withdraw the remaining funds from the pension plan. The restructuring involved five elements: (1) all active salaried employees were transferred from the existing pension plan to a new one offering increased benefits; (2) the company purchased annuities to cover the benefits that had accrued under the old plan for both retired and active employees; (3) the old plan was terminated; (4) some assets were transferred from the old plan to the new one to provide for estimated future increases in accrued benefits due to the effect of inflation on salaries; and (5) the remaining assets in the old plan reverted to the company.

The issue then became how to account for the cash that reverted to the company. The company wanted to recognize the reversion immediately as an extraordinary gain. The SEC staff disagreed.

The staff reasoned that the company had not terminated its long-term promise to provide defined retirement benefits to its employees and that the company in substance had only amended its defined benefit plan. Furthermore, the staff determined that the excess of the amount of funds in the old plan over the amount needed to cover the accrued benefits under that plan was an actuarial gain. Under Accounting Principles Board Opinion No. 8, Accounting for the Cost of Pension Plans [23], actuarial gains under a defined benefit plan generally are spread over future periods instead of being recognized immediately in their entirety. The staff took the view that the requirement to spread the gains over future periods was consistent with Staff Accounting Bulletin No. 52 [24], which permits recognition of a gain on termination of a pension plan if all obligations under the old plan are fully funded and the new plan is not linked to the old one. The FASB staff agreed with the SEC staff.

Although it would not be fruitful for my purposes to review all the arguments the company offers for disagreeing with the staff, I will mention one that is based on social policy. The company contends that the staff's view will encourage companies to change from defined benefit plans to defined contribution plans because immediate recognition would then be possible. The staff responds that most companies should be motivated to effect the transaction in order to obtain the cash upon termination of the plan rather than to account for that cash by recognizing an immediate "extraordinary" gain.

From an economist's perspective, the staff raises a good point. Regardless of the accounting treatment, the company has obtained the cash and the market absorbs the information that the event has occurred.

3.3. Remarks on location of disclosure

The cases of in-substance defeasance and reversion of excess pension plan assets raise the question of whether the effects of financial reporting should
affect the rules that govern such reporting. As an economist and academician, my inclination is that a description of economic events should be as accurate as reasonably possible. As stated in FASB Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises: “The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be. ... The role of financial reporting requires it to provide evenhanded, neutral, or unbiased information” [25]. To the extent that financial reporting has extraneous effects, such as tax consequences, I tend to think that it would be preferable that any efforts to change those consequences be directed toward the laws that impose those consequences rather than toward the rules designed to assure the accuracy of financial reporting. In the case of in-substance defeasance, for example, I think it appropriate that the reasoning supporting the rules adopted by the FASB and accepted by the Commission did not depend on the consequences for taxation or bond covenants.

Nevertheless, as an economist who accepts the efficient market hypothesis, I expect that whether disclosure is in the financial statements or in the footnotes will have little, if any, effect on the markets. Moreover, as a government official, I realize that there can be sound reasons for not changing a law, and I am inclined to think that the social consequences of any rules subject to oversight by a government agency should not be beyond consideration. Thus, I am willing to consider arguments about the social effects of accounting rules. Anyone who contends that social consequences should influence accounting rules, however, should be prepared to demonstrate that alternatives are not practicable and that the benefits of his proposal outweigh the costs. I expect that it will at best be a rare case in which such a showing can be made.

4. Conclusion

In this article I have questioned the bases for some accounting rules. This is not to say that I am ready to lead an effort to abandon any existing accounting rules. The Financial Accounting Standards Board is following an orderly process to review and develop accounting rules and that process should be permitted to run its course. Moreover, as the Commission's record, including my votes, in reviewing accounting issues and enforcing the securities laws demonstrates, public companies must abide by the rules regardless of whether some of us have reservations about the accounting treatment of certain events.

The events I have concentrated on are examples of accounting for new business techniques. From an economist's perspective, it seems likely that transactions involving the use of at least some such techniques can be reliably measured when they occur despite the fact that present accounting rules
sometimes require delaying recognition of those transactions. For this reason, I would encourage academic accountants to try to adapt some methods from finance and economics to measure relevant events.

On the other hand, from an economist's perspective, a company should not forgo use of valuable business techniques merely because the accounting rules do not permit immediate recognition and call for a different measurement. As long as disclosure of use of the techniques is complete, an efficient market will absorb that disclosure regardless of whether it occurs in the financial statements or in the footnotes. Moreover, sensible rules on recognition can preserve the integrity of financial statements, diminish the cost of absorbing information, and aid unsophisticated investors. Consequently, in the accounting issues I have considered, I have generally supported the views of the FASB and the Commission accounting staff on the form of disclosure, even though I have expected the location of the disclosure to have little market impact.

Notes

[2] Id. at ¶ 42.
[4] The SEC has not identified the public company involved.
[6] The SEC has not identified the public company involved.
[9] Id.
[10] Id.
[12] Concepts, supra note 1, at ¶¶ 93, 95.
[13] Id. at ¶ 44.
[15] Id. at ¶ 7.
[18] Id.
[20] Id. at ¶ 6.
[22] The SEC has not identified the public company involved.
[23] Accounting Principles Board, Opinion No. 8, Accounting for the Cost of Pension Plans, ¶ 31 (Nov. 1966), provides that actuarial gains and losses should be recognized in the year they occur when they "arise from a single occurrence not directly related to the operation of the pension plan and not in the ordinary course of the employer's business." Examples are gains and losses resulting from plant closings and business purchase acquisitions. *Id.*


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