Washington and Lee Law Review

Volume 64 | Issue 3 Article 5

Summer 6-1-2007

Financial Accounting and Corporate Behavior

David I. Walker

Financial Accounting and Corporate Behavior

David I. Walker*

Abstract

The power of financial accounting to shape corporate behavior is underappreciated. Advocates of positive accounting theory have argued that even cosmetic changes in reported earnings can affect share value, not because market participants are unable to see through such changes to the underlying fundamentals, but because of implicit or explicit contracts that are based on reported earnings and transaction costs. However, agency theory suggests that accounting choices and corporate responses to accounting standard changes will not necessarily be those that maximize share value. For a number of reasons, including the fact that executive compensation is often tied to reported earnings, managerial preferences for high earnings generally will exceed shareholder preferences, leading to share value reducing tradeoffs between reported earnings and net cash flows. Empirical evidence supporting the detailed predictions of these theories is mixed, but the evidence firmly establishes the power of accounting to shape corporate behavior.

The power of accounting and the divergence of interests have many implications for courts and policy makers. For example, consideration of proposals to increase conformity between tax and financial accounting rules as a means of combating tax sheltering and/or artificial earnings inflation must take into account the incentive properties of accounting standards and recognize that narrowing the gap between tax and book income will have economic consequences however the gap is narrowed. This Article considers this and other implications of the behavioral effects of accounting standards, including the possibility of setting accounting standards instrumentally as a means of regulating corporate behavior, an alternative to tax incentives, mandates, or direct subsidies.

---

* Associate Professor, Boston University School of Law. I have benefited from the helpful comments of Vic Fleischer, Keith Hylton, Calvin Johnson, Louis Kaplow, Leandra Lederman, Mike Meurer, Alex Raskolnikov, Dan Shaviro, Lynn Stout, David Weber, Chuck Whitehead, and participants in workshops at Boston University School of Law, Harvard Law School, and New York University School of Law as well as the Canadian Law and Economics, National Tax Association, and Junior Tax Scholars' Conferences. I thank Mark Gauthier for excellent research assistance.

Table of Contents

I. Introduction

Financial accounting standards, choices, and results are vitally important to the managers of U.S. public companies. Nonetheless, the courts, policy makers, and legal scholars focusing on corporate law generally ignore accounting whenever they are able—treating the subject as a black box best left to accounting professionals—without recognizing the impact of accounting on managerial decisionmaking and corporate behavior. This is unfortunate. Corporate financial accounting is too important to be left (solely) to the accountants. Courts and policy makers need to understand whether accounting standards and accounting decisions matter, and if so, how; whether managerial sensitivity to reported earnings reflects legitimate shareholder concerns, irrational behavior, or rational, but self-serving behavior; and whether accounting standards can serve a useful policy role in helping to shape managerial and corporate behavior. Consider the following examples.

In a case described in many corporate law texts and treatises, *Kamin v. American Express Co.*,[1] the company's directors voted to distribute to shareholders some depreciated securities rather than selling the securities and enjoying the benefit of a corporate tax loss. The plaintiffs' allegation, accepted by the court in considering the defendants' summary judgment motion, was that the directors had made a conscious decision to forgo about $8 million in tax savings in order to avoid a $26 million reduction in reported earnings, even though the $26 million loss had been suffered economically and would be clearly reflected on the company's balance sheet.[2] Because the American Express shareholders would be unable to use the tax loss, the primary beneficiary of this decision appeared to be the U.S. Treasury. The directors justified sacrificing after-tax cash flow for higher reported earnings, arguing that a $26 million "reduction of net income would have a serious effect on the market value of the publicly traded American Express stock."[3]

The court held that the board's good faith decision was protected by the business judgment rule and dismissed the case.[4] The court downplayed the plaintiffs' allegation that some of the directors were company managers whose compensation was based in part on reported earnings.[5] Was the earnings/cash flow tradeoff in the *Kamin* case negligent? Was it even rational? Should the court have been more skeptical that the decision was

---

1. Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (Sup. Ct. 1976).

2. The case involved shares of Donaldson, Lufken and Jenrette, Inc. that had declined in value from $30 million to $4 million. *Id.* at 809. The loss on the stock was water under the bridge. The only question before the directors was whether the stock should be sold by American Express, providing a tax benefit to offset other income, but also a reduction in earnings; or distributed to shareholders as a dividend. *Id.* In the latter case, the alternative selected by the directors, the tax benefit would be lost entirely—the shareholders would not be entitled to use it—but American Express's loss on the stock would be reflected only on its balance sheet, not on its income statement. *Id.* at 809–10.

3. *Id.* at 811.

4. *Id.* at 812.

5. *See id.* (dismissing the claim that the decision was motivated by self-interest as being "highly speculative").

in good faith and not self-serving behavior on the part of the inside directors?

Consider next the battle that has been waged during the last decade over the accounting treatment of compensatory stock options. The Financial Accounting Standards Board (FASB), the private body empowered by the Securities and Exchange Commission (SEC) to set accounting standards, formally proposed in 1993 that stock option expense be recorded and subtracted from reported earnings similar to all other compensation expense.[6] The corporate lobby managed to defer mandatory expensing for twelve years until the FASB finally forced through a rule in 2004.[7]

The effect of mandatory option expensing will be to reduce reported earnings for companies that use options. Corporate interests opposing the new standard have argued that expensing will reduce share values and drastically reduce or preclude the use of options as a compensation device.[8] Some economists argue that the accounting treatment is irrelevant and that managerial resistance was irrational under traditional economic ways of thinking.[9] Members of Congress weighed in on this one, but on both sides of the question.[10] Was managerial resistance to option expensing irrational or self-serving, or did it reflect legitimate concerns about the effect of expensing options on share value?

Next, increased consistency between financial and tax accounting has been proposed as a response both to tax sheltering and artificial earnings inflation.[11] Differences between financial (or book) accounting and tax accounting allow

---

6. FIN. ACCOUNTING STANDARDS BD., EXPOSURE DRAFT: PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS: ACCOUNTING FOR STOCK-BASED COMPENSATION, para. 1–4 (Dec. 1993) (on file with the Washington and Lee Law Review).

7. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123, SHARE BASED PAYMENT 1, 25–26 (rev. Dec. 2004) [hereinafter SFAS No. 123R] (mandating "fair value" accounting for stock options beginning in 2005 and 2006).

8. *See, e.g.*, Wick Simmons, *The Best Option*, WALL ST. J., Jan. 31, 2003, at A10 ("[I]f companies are forced to treat options like salaries or manufacturing costs, many will decide they can't afford to continue this form of potential compensation.").

9. *See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 860 (2002) (arguing that "[t]here is substantial evidence that managers respond to accounting concerns in ways that seem irrational to financial economists").

10. *See* Patricia M. Dechow et al., *Economic Consequences of Accounting for Stock-Based Compensation*, 34 J. ACCT. RES. (SUPP.) 1, 3–4 (1997) (discussing two opposing attempts to legislate with respect to the matter).

11. *See, e.g.*, George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 224–29 (2001); Mihir A. Desai, The Degradation of Reported Corporate Profits 22 (July 2005) (unpublished working paper, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=758144.

firms to exploit tax shelters that decrease taxable income without affecting book income and artificially inflate reported earnings without incurring higher corporate taxes. Requiring firms to adopt the same accounting conventions for both purposes would force them to trade off taxes against reported earnings. Assuming some managerial discretion, commentators have generally assumed that the primary result of increased book-tax conformity would be reduced reported earnings because managers would act to minimize taxes and maximize after-tax cash flows.[12] Does this view properly reflect the importance of reported earnings to management, or would shareholders likely suffer as a result of increased book-tax conformity as managers forwent valid tax deductions in order to keep reported earnings high? More importantly, what would be the broader economic consequences of eliminating the gaps between financial and tax accounting?

Finally, consider a hypothetical accounting standard change that has the effect of decreasing reported expenses (and thus increasing reported earnings) related to the purchase of a certain class of assets. Given managerial sensitivity to reported earnings, as demonstrated in *Kamin*, the stock option expensing saga, and numerous studies recounted below, would such an accounting change serve as a valuable incentive device, perhaps as an alternative to tax incentives? This Article argues that the stock option accounting regime in place over the last decade acted as an accounting incentive and helps explain the widespread use of options. This was largely unintentional and probably not salutary, but the impact of accounting rules on compensation design suggests the potential for instrumental use of accounting.

At bottom, we have two primary questions: Do accounting rules affect corporate behavior? And, if so, why? Thoughtful consideration of these questions requires exploration of accounting theory and related empirical evidence. Accounting theory seeks to explain how accounting standards affect share prices and corporate behavior and how firms choose between permissible standards. One aim of the first part of this Article is to introduce the legal academic community to the dominant accounting theory over the last twenty years—positive accounting theory—which employs transaction cost economics

12. *See, e.g.*, Calvin H. Johnson, *GAAP Tax*, 83 TAX NOTES 425, 427 (1999) (arguing that book-tax conformity would cause a significant drop in GAAP income); Yin, *supra* note 11, at 227 (noting that a tax based primarily on financial income could lead some companies to report lower earnings to reduce taxes); Michelle Hanlon & Terry Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues* 28 (Nat'l Bureau of Econ. Research, Working Paper No. W11067, 2005) (noting that book-tax conformity could lead to a race to the bottom on effective tax rates). To be sure, none of these sources suggest that firms would completely ignore reported earnings, but the general tenor is that tax effects would likely dominate.

to describe why accounting standards and practices would be relevant despite the ability of the capital markets to "see through" various accounting presentations to the underlying value of securities.[13] However, Part II also emphasizes the importance of managerial agency costs in explaining accounting choices that apparently reduce share value.

The empirical literature on accounting and corporate behavior, which this Article reviews in detail in Part III, confirms that accounting rules and procedures matter. Or, more importantly, managers act as if accounting matters, and thus accounting rules affect corporate behavior. That evidence includes additional examples of tax benefits being sacrificed to boost or maintain earnings, as in *Kamin*; operational changes made as a result of changes in accounting standards; and survey responses in which managers admit sacrificing cash flow for earnings. However, although some of the evidence is consistent with share value enhancing aspects of positive accounting theory, much of the evidence is equally consistent with a manager-driven or agency cost theory of accounting choice. To put it bluntly, accounting clearly matters; it is less clear why.

However, despite the empirical uncertainty, we cannot punt on the motivational question. In evaluating corporate decisions, like those in *Kamin* or managerial opposition to stock option expensing, it is obvious that accounting matters; the issue is whether these actions can possibly be in the shareholders' interests. Part IV of this Article argues that a share value-maximizing account is improbable in such cases. Based on our current understanding of accounting theory and evidence, we cannot be certain that the American Express directors in *Kamin* were negligent or disloyal, or that managerial opposition to stock option accounting was largely self-serving, but that suspicion is reasonable.

Part V of this Article considers the behavioral effects of accounting in the context of increased book-tax conformity. Positive accounting theory suggests that firms seeking to maximize share value in a world of increased conformity would not adopt a strategy of ignoring reported earnings and minimizing taxes. However, this Article argues that managers would go even further in sacrificing

---

13. *Infra* Part II.B. *See generally* ROSS L. WATTS & JEROLD L. ZIMMERMAN, POSITIVE ACCOUNTING THEORY (1986); Ross L. Watts & Jerold L. Zimmerman, *Positive Accounting Theory: A Ten Year Perspective*, 65 ACCT. REV. 131 (1990).

Although legal academics generally are familiar with the efficient capital markets hypothesis and the capital asset pricing model, which form the basis of modern accounting theory, references in the legal literature to positive accounting theory are rare. A "terms and connectors" search of the "Journals & Law Reviews Combined" database in Westlaw for "positive accounting theory" produces only ten hits.

tax benefits for higher reported earnings, in all likelihood forgoing legitimate tax deductions and impairing share value.[14]

More importantly, irrespective of *why* accounting matters, Part V argues that we should think of financial accounting standards as creating incentives just like the tax rules. Thus, differences between the two sets of rules, such as depreciation rules that allow firms acquiring capital assets to report higher earnings to investors than to the tax authorities, can be thought of as tax incentives, accounting incentives, or both. And increased book-tax conformity, whether achieved by conforming tax with book, book with tax, or something in between, could have adverse consequences for the economy.

Once we recognize that financial accounting standards have strong behavioral effects and economic consequences, the natural question to ask is whether this power should be harnessed and explicit accounting incentives embraced as a public policy tool, a supplement to the direct subsidies, mandates, and tax incentives currently used by Congress to shape corporate behavior. This provocative idea is considered in Part VI.

Financial accounting incentives could be powerful levers and could reach organizations indifferent to tax incentives. But there would be costs. First, purposeful deviation from economic accounting, the accounting treatment that most closely follows the economics of the transaction, would result in degradation of the information content of accounting statements and greater costs to the users of these statements.[15] A second potential cost lies in the introduction of additional lobbying into the accounting standard-setting process and the possibility of regulatory capture by the interest group with the most at stake—management.[16] In many ways the costs and benefits of providing explicit accounting incentives and tax incentives are similar. The difference is that mixed purposes, congressional involvement, and the attendant lobbying and capture issues are unavoidable in the tax realm, or perhaps more importantly, are irretrievably entrenched. This is not the case for financial accounting, which is subject to much less political infighting today than is tax. Thus, although an omniscient, benevolent, and disinterested power could increase social welfare through judicious manipulation of accounting rules, we must recognize that Congress is not such a power. While remaining open to the possibility of instrumental accounting, this Article concludes, for now, that

14. *Infra* Part V. Negative earnings effects possibly exert greater influence over discrete, one-time decisions, such as major asset dispositions, than ongoing activities, such as the choice of an accounting method.

15. *Infra* Part VI.C.2.

16. *Infra* Part VI.C.3.

social welfare is probably best served by minimizing consideration of nonaccounting consequences in the standard-setting process.

II. Accounting Theory

Public companies prepare audited financial statements that are relied upon by investors and others. Most important are the income statement, which summarizes a company's performance over the previous year or quarter, and the balance sheet, which provides a snapshot of the overall financial position of the company as of the end of the period. The numbers that receive the greatest attention in the financial press are the net profits or earnings figures from the income statement, often portrayed as earnings per share of stock outstanding. The art of accounting, though, lies in the detail, in determining how various transactions—purchases, sales, leases, commitments to retirees, etc.—are to be accounted for. Accountants rely on a body of rules known as generally accepted accounting principles (GAAP). As the name implies, many of these rules have not been mandated but have become accepted by the accounting profession over time. Ultimately, however, the SEC is responsible for maintaining the integrity of the securities markets and has delegated to the FASB the power to promulgate mandatory and permissive rules of accounting practice as needed. As a result, companies today face an array of mandatory rules as well as choices between generally accepted treatments in preparing their financial statements.

Accounting theory seeks to explain how accounting standards affect share prices and corporate behavior and how firms choose between permissible standards. Our analysis begins with an exploration of the well-known efficient capital markets hypothesis (ECMH) and the less well-known (to legal academics, anyway) positive accounting theory. These theories suggest that accounting matters not because stock valuation is directly affected by accounting choices or standards but because contracts and regulatory costs depend explicitly or implicitly on reported earnings, and these arrangements are sticky. Because of transaction costs, reported earnings can have an indirect effect on share prices. Next, this Part argues that corporate decisionmakers have additional incentives beyond share price maximization to prefer higher reported earnings, including earnings-based bonuses. Ultimately, the relationship between financial accounting and corporate behavior depends on managerial agency costs as well as other transaction costs.

A. *The Efficient Capital Markets Hypothesis and the Capital Assets Pricing Model*

Accounting and finance researchers generally believe that a change in accounting standards or practices that increases or decreases reported earnings, but has no impact on cash flow, transaction costs, or on the information provided to the marketplace, should have no effect on stock prices.[17] Securities markets should see through such cosmetic accounting adjustments to the underlying fundamentals that determine valuation. This view follows directly from the ECMH and the capital asset pricing model (CAPM).[18]

The CAPM simply assumes that the value of a company, and hence its stock price, is a function of the cash flows and rates of return that are expected over time.[19] There are three versions of the ECMH. The weak form holds that securities prices reflect all information incorporated in past prices. The semi-strong form of the ECMH holds that securities prices reflect all published information. The strong form holds that prices reflect all discoverable information.[20] If we limit our inquiry to changes in accounting standards and choices that involve only the presentation of published information, we need only accept the semi-strong version of the ECMH to conclude that accounting has no direct effect on stock valuation.[21] Although there is some evidence to the contrary, most economists believe that markets are at least semi-strong efficient.[22]

---

17. Some accounting decisions, such as the choice between last-in, first-out (LIFO) and first-in, first-out (FIFO) inventory accounting, affect a firm's tax burden and after-tax cash flow. WATTS & ZIMMERMAN, *supra* note 13, at 73. These accounting decisions would be expected to have share price implications under this theory.

18. *See, e.g.*, *id.* at 72–74 (discussing the capital structure irrelevance proposition); Watts & Zimmerman, *supra* note 13, at 132–33 (discussing accounting irrelevance theory).

19. WATTS & ZIMMERMAN, *supra* note 13, at 72–74.

20. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 337 (8th ed. 2006) (discussing the three forms of market efficiency).

21. For example, suppose firms ABC and XYZ are identical except for their accounting for an expense of $0.10 per share. ABC reports earnings of $1.00 per share and discloses the $0.10 per share expense in the footnotes to its accounting statements. XYZ subtracts the expense in its income statement reporting earnings of $0.90 per share. Under the naïve investor view that runs counter to the semi-strong ECMH, XYZ would trade for less than ABC. Suppose that the price-to-earnings ratio for firms in this industry with prospects and risks similar to ABC and XYZ is 20. Under the naïve investor view, ABC would trade at $20 per share, while XYZ would trade for $18 per share. However, because the expense is fully disclosed in both cases, the semi-strong version of the ECMH predicts that these firms would have an identical share price. The market would treat each as earning $0.90 per share.

22. *See* BREALEY ET AL., *supra* note 20, at 337–39 (discussing the research on the semi-

Lynn Stout, Lawrence Cunningham, and others have argued that markets may not be as efficient as economists generally presume,[23] yet these criticisms do not undermine the modest claim made above. Stout's critique is primarily directed at assertions of strong form market efficiency and an even stronger view called fundamental value efficiency.[24] The latter is the theory that prices not only reflect all available information but also provide the best estimate of the fundamental value of the underlying asset.[25] Fundamental value efficiency is difficult to square with market corrections, so these criticisms are well taken. But in considering the differential impact of competing accounting standards or choices, we are not concerned with fundamental equity values, only with the impact of accounting on stock prices relative to one another or from one period to another. With regard to these issues, Stout argues that the cost of arbitrage and of acquiring and processing information, particularly technical information, undermines the efficiency with which information is impounded into prices.[26]

Although I agree with Stout's criticisms as applied to strong form market efficiency theory, and perhaps to some examples of semi-strong efficiency, I am skeptical of her argument that accounting practices affect stock prices because of informational inefficiency. As an example of an accounting practice that may affect prices if markets are informationally inefficient, Stout mentions the debate over the treatment of compensatory stock options.[27] This debate centers on whether stock option expense should be deducted from reported earnings in

---

strong form of the efficient-market hypothesis); Thomas D. Fields et al., *Empirical Research on Accounting Choice*, 31 J. ACCT. & ECON. 255, 279–81 (2001) (noting that research in the 1970s supported market efficiency; that researchers in the 1980s and early 1990s assumed efficiency and looked for other explanations for why accounting would matter, i.e., positive accounting theory; and that some evidence produced in the 1990s is inconsistent with efficient markets and investor rationality, but that this evidence is insufficient to draw strong inferences); S.P. Kothari, *Capital Markets Research in Accounting*, 31 J. ACCT. & ECON. 105, 120–21 (2001) (noting anomalies that challenge the ECMH, such as the tendency of markets to under-react to earnings surprises, but pointing out methodological concerns with such studies).

23. For their arguments, see Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002), and Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003).

24. *See* Stout, *supra* note 23, at 637, 639 (describing the most common definition of an efficient market as one that reflects all available information); *see also id.* at 639–50 (critiquing the fundamental value efficiency view).

25. *See id.* at 640 (differentiating between "informational efficiency" and "fundamental value efficiency").

26. *Id.* at 651–56. Stout also explores the effects of heterogeneous investor expectations and investor irrationality on efficient market claims, but these limitations on efficiency, if significant, pose less of a challenge to the semi-strong model. *See generally id.* pts. II, IV.

27. *Id.* at 657 n.100.

the body of the financial statement, as the FASB now requires,[28] or only reported in the footnotes to the accounting statements. It is important to recognize, however, that the "footnote" provided exactly the same information that is provided in the body of company financial statements under the new rule. Formerly, companies that did not "expense" options were required to present pro forma income statements revealing the net income and earnings per share figures that would have resulted had options been expensed.[29] Thus, while I agree with Stout that the cost of acquiring and processing information can limit market efficiency in some circumstances, it is difficult to understand how an income statement found on page three of the financial statement is any more informative than the exact same statement found on page thirty.[30]

Of course, the stock option expensing example is the toughest case for those arguing that accounting standards affect stock prices because of informational inefficiencies. Other changes to accounting standards could have greater impact on the information presented to investors. I think we can safely say, however, that a change in standards that has no material effect on the information available to investors should have no direct effect on stock prices.

Similarly, it is difficult to understand how the accounting issue presented in *Kamin* could have had any direct effect on the stock price of American Express. Recall that the directors chose to distribute rather than sell depreciated securities the company was holding as an investment.[31] Sale of the

---

28. *Infra* note 95 and accompanying text.

29. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: ACCOUNTING FOR STOCK-BASED COMPENSATION para. 45 (Oct. 1995) [hereinafter SFAS No. 123] (setting forth the reporting requirements). Returning to the example above, see *supra* note 21, if the $0.10 per share expense is related to compensatory stock options, the footnoting option would allow ABC to report earnings of $1.00 per share in its income statement, but ABC would be required to report pro forma earnings of $0.90 per share in the footnotes to its financial statements.

30. The location of disclosure could affect the information provided to the market if footnoted information is deemed to be less important or reliable than information provided in the body of the financial statement. *See* Anwer S. Ahmed et al., *Does Recognition Versus Disclosure Matter? Evidence from Value-Relevance of Banks' Recognized and Disclosed Derivative Financial Instruments*, 81 ACCT. REV. 567, 568–69 (2006) (finding evidence that recognized derivative instruments are more value-relevant than disclosed-but-unrecognized derivatives and suggesting that the difference may be related to reliability or costs of information processing). However, in the case of footnoted option expense, the calculation methods were tightly controlled by the FASB and market participants should have realized that but for political opposition, the FASB would have required option expensing in the body of financial statements years ago. Thus, the placement of option expense information should not have provided any material information to the market.

31. *See* Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 809 (Sup. Ct. 1976) (discussing the facts of the case).

securities would have provided a potential $8 million tax benefit, but also would have reduced reported earnings by $26 million.[32] Perhaps if the directors had been able to hide the investment loss from analysts by distributing the securities, the impact on the price of American Express shares might have been dampened. American Express stockholders, however, appeared to have been well aware of the economic loss that had been suffered. The company had announced that the depreciated securities would be distributed in kind as a special dividend and apparently had provided enough information for some shareholders to realize that this action would result in the company forgoing a sizeable tax benefit.[33] Ultimately, the board held a special meeting to reconsider distribution versus sale.[34] Can there be any doubt at this point that the economic loss suffered had been fully incorporated in the stock price of American Express and that the additional step of reducing corporate earnings by the amount of the loss would have provided no new information to the market?

There can be no real doubt. Nonetheless, Lawrence Cunningham argues that the American Express directors still may have outsmarted the market by distributing the securities and that their action reflected healthy skepticism about market efficiency.[35] The thrust of his and other similar arguments is that investor cognitive biases—including loss aversion (the tendency to place greater importance on losses than gains), overconfidence (the belief that we are all better than average drivers, stock pickers, etc.), and availability (the tendency to place greater weight on more recent events)—undermine the efficiency of the capital markets.[36] However, Cunningham does not explain which cognitive bias would cause "market participants [to] focus on the income statement and earnings per share rather than on the balance sheet and owner's equity,"[37] and it is not obvious which, if any, cognitive bias would be at work here. Perhaps some investors overconfidently rely on raw earnings numbers or rely excessively on reported earnings and discount footnotes and balance sheets because the latter are less salient. But this sounds less like bias and more like

32. *Id.* at 809–10.

33. *Id.*

34. *Id.* at 813–14.

35. Cunningham, *supra* note 23, at 823–24.

36. *See id.* at 775, 783 (discussing investor biases); *see also* BREALEY ET AL., *supra* note 20, at 337–39 (same). As Stout notes, the behavioral finance field has experienced explosive growth. I cite Cunningham as one example because he has specifically referenced the *Kamin* case, but many others could be cited. *See* Stout, *supra* note 23, at 660 nn.115–17 (naming behavioral finance sources).

37. Cunningham, *supra* note 23, at 823–24.

laziness. More generally, while evidence exists that market participants suffer from cognitive biases, it is not clear that these biases affect market prices.[38]

B. Positive Accounting Theory

A believer in the semi-strong view of the ECMH might be tempted to conclude from the foregoing discussion that accounting standards and accounting choices are irrelevant, and this irrelevancy view held sway in the academic community for many years.[39] However, researchers investigating company choices among acceptable accounting alternatives found enough systematic variation to doubt the irrelevance theory and seek alternative explanations. For example, firm size and leverage (the ratio of corporate debt to equity) both appear to be associated with accounting choice, a result at odds with an irrelevancy view of accounting.[40] Findings such as these led researchers to search for indirect effects of accounting on share value, a movement known as positive accounting theory.[41]

The ECMH only says that the securities markets see through cosmetic accounting changes. This does not necessarily mean that reported earnings are irrelevant. Theorists note that some corporate contracts are tied to reported earnings, including debt covenants and executive compensation agreements.[42]

---

38. *See* BREALEY ET AL., *supra* note 20, at 343–47 (questioning behavioral finance explanations for market anomalies and noting, inter alia, that financial institutions employ behavioral finance experts to assist them in overcoming those biases).

To be fair, many finance executives apparently share Stout's and Cunningham's skepticism regarding the efficiency of the capital markets. As discussed more fully below, a recent survey of over 400 CFOs, treasurers, and other financial executives found that most were willing to forgo positive net present value projects in order to achieve quarterly earnings targets. John R. Graham et al., The Economic Implications of Corporate Financial Reporting 14–15 (Jan. 11, 2005) (unpublished working paper, on file with the Washington and Lee Law Review). A majority of the executives expressed a belief that failure to achieve quarterly earnings targets adversely affects a company's share price because such failure undermines confidence in management. *Id.* at 14. Some of the respondents doubted the ability or willingness of even sophisticated investors to look through managed earnings to the underlying cash flows. *Id.* at 26–27.

39. *See* Robert W. Holthausen & Richard W. Leftwich, *The Economic Consequences of Accounting Choice*, 5 J. ACCT. & ECON. 77, 80 (1983) (discussing early tests finding no stock price reaction to changes in accounting techniques except for changes affecting taxes); Watts & Zimmerman, *supra* note 13, at 132–34.

40. *See* Holthausen & Leftwich, *supra* note 39, at 79 (discussing the systematic relationship between firm specifics and accounting choice).

41. *See* Watts & Zimmerman, *supra* note 13, at 133 ("To predict and explain accounting choice researchers had to introduce information and/or transaction costs.").

42. *See id.* at 133 (discussing factors affecting accounting choice). For a discussion of

Renegotiating these contracts to adjust for accounting changes can be costly, while failure to renegotiate in the face of a purely accounting-driven change in earnings can be costly as well.[43] In addition, if an accounting-driven increase in reported earnings is difficult to distinguish from an increase in profits arising from business fundamentals, the earnings bump could have political ramifications, such as increased exposure to tax hikes.[44] Finally, mandatory accounting changes that reduce the freedom to select optimal accounting techniques could reduce the value of financial statements for private contracting.[45] All of these indirect effects of reported earnings on share value are referred to as contracting costs in the positive accounting theory literature.

Transaction costs resulting from sticky contracts and political costs resulting from an apparent surge in profits affect a company's cash flows. Thus, this explanation is perfectly consistent with the ECMH and CAPM. In developing the accounting irrelevance theory, scholars had assumed that accounting standards and practices did not affect transaction costs. The advance made by positive accounting theorists was to eliminate this simplifying assumption and begin to explain the relevance of accounting to share price.[46]

Consider the impact of accounting on corporate debt covenants. Traditionally, these covenants were based on GAAP accounting, which means that they were tied to reported earnings, and they usually were based on "rolling" GAAP, that is, GAAP in effect at the time of calculation.[47]

---

associated contracting costs, see Holthausen & Leftwich, *supra* note 39, at 84–88.

43. *See* WATTS & ZIMMERMAN, *supra* note 13, at 215, 215 n.4 (discussing the costs of renegotiating a debt contract as well as the costs of a breach in the absence of renegotiation).

44. *See id.* at 222–23 (discussing the relationship between accounting practices and the political process).

45. *Id.* at 219; Daniel W. Collins et al., *The Economic Determinants of the Market Reaction to Proposed Mandatory Accounting Changes in the Oil and Gas Industry: A Cross-Sectional Analysis*, 3 J. ACCT. & ECON. 37, 43 (1981). In addition, a change in accounting standards may affect the reliability of information provided to the markets. New standards that reduce reliability would have a negative effect on firm value by increasing contracting costs generally. Hassan Espahbodi et al., *Impact on Equity Prices of Pronouncements Related to Nonpension Postretirement Benefits*, 14 J. ACCT. & ECON. 323, 327 (1991).

46. An obvious analogy exists between the evolution of positive accounting theory and positive finance theory. Miller and Modigliani demonstrated in 1961 that corporate financing decisions, such as dividend payout policies, are irrelevant in the absence of transaction costs. Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411, 431–32 (1961). Subsequent researchers demonstrated that taxes, agency costs, and other imperfections in the market render corporate finance relevant. BREALEY ET AL., *supra* note 20, at 415–35.

47. Richard Leftwich, *Evidence of the Impact of Mandatory Changes in Accounting Principles on Corporate Loan Agreements*, 3 J. ACCT. & ECON. 3, 6 (1981). Presumably, rolling GAAP was preferred to "frozen" GAAP because of the added cost of maintaining non-

Renegotiation of debt covenants would be difficult and costly, particularly with respect to covenants associated with publicly held debt, which generally require for amendment a two-thirds vote of the outstanding debt.[48] Violation of debt covenants could be costly as well, resulting in restrictions on the payment of dividends, limitations on merger activity, and other adverse consequences.[49] Thus, an accounting choice, an operational decision, or a mandatory change in accounting standards that reduced earnings could reduce firm value by increasing the risk of costly debt covenant violations, even if the earnings reduction was completely cosmetic. As Richard Leftwich pointed out, reduction in firm value should not exceed the lesser of the cost of renegotiating the covenants, redeeming the debt (if possible), default, or adjusting operations to avoid default.[50] Unless renegotiation was costless, however, an income-reducing accounting change would reduce the value of a firm with the debt covenants described to some extent.

As suggested in the next Part, much effort has gone into attempts to verify the debt covenant hypothesis, and it is clear that there is something to this story. Many studies have shown that corporate leverage helps predict accounting choices and operating decisions with accounting implications in ways consistent with the theory. However, there is reason to believe that the role of debt and debt covenants in accounting choice is waning. First, several studies indicate that the use of covenants restricting bond issuers from paying dividends or incurring additional debt has declined substantially in recent years.[51] Second, one study has demonstrated that fixed or frozen GAAP covenants have increased in prevalence.[52] Both of these changes reduce the

---

GAAP accounts for the purpose of policing debt covenants.

48. *Id.* at 8.

49. *Id.* at 5–6.

50. *Id.* at 7.

51. *See* Joy Begeley & Ruth Freedman, *The Changing Role of Accounting Numbers in Public Lending Agreements*, 18 ACCT. HORIZONS 81, 82 (2004) (examining public debt issuances and finding that the presence of accounting-based restrictions on paying dividends and incurring additional debt fell from about half of issuances in the late 1970s, to about a quarter in the late 1980s and early 1990s, to less than 10% in 1999–2000); Robert C. Nash et al., *Determinants of Contractual Relations Between Shareholders and Bondholders: Investment Opportunities and Restrictive Covenants*, 9 J. CORP. FIN. 201, 218 tbl.3 (2003) (examining a sample of bonds issued in 1989 and 1996 by U.S. companies and finding that the use of covenants restricting dividend payments declined from 40% to 21%, while the use of covenants limiting additional borrowing declined from 40% to 27%).

52. *See* Mary Beth Mohrman, *The Use of Fixed GAAP Provisions in Debt Contracts*, 10 ACCT. HORIZONS 78, 84 (1996) (finding an increasing tendency to fix accounting methods in debt contracts with over 50% of contracts executed after 1982 containing fixed GAAP provisions).

aggregate cost to U.S. companies of accounting changes, choices, or operational decisions that reduce reported earnings.

Moreover, the various contracting costs that have been identified do not all run in the same direction. For example, Watts and Zimmerman postulated that firms would wish to keep reported earnings low to stave off tax increases, suggesting that income-reducing standard changes or accounting choices would reduce political costs.[53] If renegotiation of executive compensation agreements is costly, mandatory accounting changes that reduce reported earnings would be resisted by management, but the effect on firm value would be ambiguous. At one level reducing reported earnings in an environment of sticky compensation contracts should increase firm value by reducing compensation payments. On the other hand, reducing incentive compensation could adversely affect firm value. The optimal contracting story has no directional prediction. Under this theory, mandatory standard changes that reduce accounting choices reduce firm value whether the new standard results in higher or lower reported earnings.[54]

C. *Shareholder and Manager Appetite for Earnings*

In the absence of transaction costs, cosmetic accounting changes would have no impact on share value, and loyal directors would simply ignore the impact of their decisions on reported earnings. The decision to sacrifice cash flow for earnings, as in *Kamin*, would clearly run counter to shareholder interests. Once we introduce positive accounting theory, however, the picture is more complex. Assuming that contracting costs are nontrivial, loyal managers would need to balance earnings effects against other cash flow effects, and even cosmetic changes in accounting could affect share value.

Let's assume that debt covenant costs dominate other contracting costs so that a reduction in reported earnings resulting from operational decisions or a mandatory change in accounting standards reduces firm value. Share value maximization would require managers to take these costs into account. But there are conflicting forces. As in *Kamin*, steps taken to increase reported earnings often result in increased taxes. A proposed change in accounting standards may decrease reported earnings and increase the expected cost of default on debt covenants, but opposing the change may entail monetary and

53. WATTS & ZIMMERMAN, *supra* note 13, at 231. *Cf.* Simon Romero & Edmund L. Andrews, *At Exxon Mobil, a Record Profit but No Fanfare*, N.Y. TIMES, Jan. 31, 2006, at A1 (covering Exxon Mobil's announcement of a record $36 billion in annual profits and efforts by the company to play down the news).

54. WATTS & ZIMMERMAN, *supra* note 13, at 219–20.

perhaps political costs. Thus, while shareholders will have some appetite for accounting-induced increases in reported earnings, this appetite will be tempered by other costs. Share value will be maximized by maximizing after-tax cash flow, but this requires striking a balance between the contracting costs associated with reported earnings and other cash flow effects. The optimal point on the continuum between earnings maximization and maximization of other cash flows will depend on firm characteristics. For example, firms that are highly leveraged will face relatively greater costs from reduced reported earnings. Of course, even calculating the optimal point along this continuum is costly, and for some firms, share value may indeed be maximized by simply ignoring the effect of reported earnings (perhaps the case for unleveraged companies) or by maximizing reported earnings and ignoring cash flow (unlikely, but conceivably the case for highly leveraged firms in the vicinity of insolvency).

In a world without agency costs, managers' appetites for reported earnings would mirror that of shareholders, but in the real world, we should expect managers to have a stronger appetite than shareholders for earnings. First, and most obviously, managerial compensation may depend on reported earnings, independent of the effect of earnings on share price. Accounting-based bonuses have a long pedigree and remain common today.[55] Reported earnings often factor into managerial bonuses both as an element in bonus calculations and as a ceiling on bonus payouts.[56] In fact, studies consistently demonstrate that earnings, earnings per share, and related measures such as earnings before income taxes are the most commonly employed performance measures for executive bonuses.[57]

55. *See* Susan Eichen & Eric Scoones, *Annual Incentive Plan Design Considerations*, *in* EXECUTIVE COMPENSATION 35, 37, 49–50 (Yale D. Tauber & Donald R. Levy eds., 2002) (noting that the "vast majority" of U.S. companies maintain annual incentive plans and that financial measures of performance—principally income-based measures—are among the most commonly used metrics in these plans).

56. JEROLD L. ZIMMERMAN, ACCOUNTING FOR DECISION MAKING AND CONTROL 185 (1995).

57. *See* Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS 2485, 2500–03 (Orley Ashenfelter & David Card eds., 1999) (reporting results of a 1996–1997 Towers Perrin survey of 177 large U.S. corporations); *see also* Christopher D. Ittner et al., *The Choice of Performance Measures in Annual Bonus Contracts*, 72 ACCT. REV. 231, 238–40 (1997) (analyzing bonus plans of 317 firms for 1993 and 1994 and reporting that the three most popular financial performance measures for CEO bonuses were earnings per share, net income, and operating income); Tod Perry & Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62 J. FIN. ECON. 453, 466 tbl.4 (2001) (finding that earnings—including net income, net profit, and net income minus nonrecurring events—and earnings per share were the most commonly employed performance measures for determining CEO bonuses for a random sample of S&P 500 and MidCap 400

In recent years, of course, equity-based compensation has grown to overshadow traditional bonuses (although accounting-based bonuses generally have not been reduced, much to the consternation of corporate pay critics).[58] However, the latest trend is to tie receipt of equity-based pay to accounting performance, increasing the sensitivity of managerial compensation to financial accounting. Thirty percent of major U.S. corporations recently surveyed by Mercer Consulting based a portion of CEO equity compensation on the achievement of accounting-based performance targets.[59] For example, stock option grants increasingly are made contingent on a corporation's achievement of earnings, revenue growth, or other financial targets.[60]

In addition, high reported income may have an indirect effect on a manager's compensation. Even if information presentation has no direct effect on stock prices and little direct effect on compensation, managers may be able to use high reported earnings as a factor in negotiating additional compensation. Compensation consultants working for senior executives are masters at identifying the metrics that allow their bosses to report better than average performance, justifying higher than average compensation.[61] Artificially inflating reported earnings is one way to shine relative to one's peers.

Positive accounting theorists have long recognized that managers of firms with earnings-based bonuses will tend to choose earnings-increasing accounting practices and favor earnings-increasing standards.[62] The more general point that even executives of companies that lack explicit earnings-based bonuses will share these motivations has not been widely recognized in the accounting

---

firms in 1995).

58. According to a recent study, equity-based compensation accounted for 72% of total compensation paid to the top five executives of S&P 500 companies in 2000 and 2001, and then declined to 55% of total compensation for 2003, the last year of data reported. Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 290 (2005). This study also found that although average equity-based pay received by CEOs of S&P 500, Mid-Cap 500, and Small-Cap 600 companies nearly tripled between 1993 and 2003, cash compensation still increased by about 40% across this period. *Id.* at 291.

59. Joann S. Lublin, *Boards Tie CEO Pay More Tightly to Performance—Options Grants May Depend on Meeting Financial Goals*, WALL ST. J., Feb. 21, 2006, at A1.

60. *Id.*

61. For a discussion of the influence of compensation consultants, see LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 71 (2004); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 42–50 (1991); and Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 790–91 (2002).

62. Watts & Zimmerman, *supra* note 13, at 138; WATTS & ZIMMERMAN, *supra* note 13, at 256.

literature, perhaps because it is a difficult proposition to test. However, it is important to recognize the difference between this account and the other contracting cost stories. Assuming that accounting-induced increases in executive compensation do not provide commensurate increases in productivity, an earnings-increasing change in accounting standards or practices tends to reduce share value because of the increased compensation payout. But despite the reduction in share value, the executive decisionmakers may very well favor the change because they receive a portion of the increased compensation that results. Here, there is a divergence of interests between managers and shareholders that does not arise in examining the impact of reported earnings on debt contracts or political costs. This is still a transaction cost story, but in the agency cost vein.[63]

Of course, if executive compensation agreements were set in an efficient market, managers could not profit from earnings-increasing changes in accounting practices or standards. Pay contracts would be adjusted accordingly. But theory and evidence suggest that this market is not perfectly efficient; that to some extent, managers control the pay-setting process; and that overall pay levels may be capped by investor or financial press outrage, in which case subtle means of increasing compensation, such as through manipulating earnings-based bonuses, may be effective.[64]

This view suggests that in some cases, management's primary concern with a proposed accounting change may be that the new rule will result in increased exposure and scrutiny of certain elements of their compensation. Consider the FASB's decision to require companies to shift stock option expense reporting from footnote to income statement. This change will reduce earnings, and it could have negative effects on earnings-based bonuses and other forms of compensation. But perhaps more importantly, the new reporting requirement may make option compensation more visible to corporate critics and shareholder advocates, which may result in pressure on directors to limit options.[65] Thus, resistance to stock option expensing may appear to reflect a stronger managerial appetite for earnings than truly exists.

---

63. For the seminal article on the manager-shareholder agency problem, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

64. *See* BEBCHUK & FRIED, *supra* note 61, at 68–70 (discussing ways in which increased compensation is camouflaged to prevent investor outrage); Bebchuk et al., *supra* note 61, at 786–88 (discussing outrage as a constraint on executive compensation).

65. *See* Dechow et al., *supra* note 10, at 18 (concluding that managerial resistance to stock option expensing was driven by concerns relating to the scrutiny of option compensation); *see also* Bebchuk et al., *supra* note 61, at 813 (arguing that salience is a critical factor limiting executive compensation). For further discussion, see *infra* notes 117–19 and accompanying

Direct compensation aside, managers may have other reasons for seeking high reported earnings. For example, some managers may hold an honest, but mistaken, belief that information presentation *directly* affects stock prices. They may subscribe to the naïve investor view of the market that runs counter to the semi-strong version of the ECMH and holds that investors take earnings at face value and reward firms that report high earnings with high share prices. Obviously, managers who honestly thought that reported earnings directly affected their stock price would place a high value on increasing those earnings.[66]

Finally, managers may be socialized into placing inordinate importance on earnings, achieving earnings targets, and maintaining steady earnings improvements by the focus of stock analysts on these metrics. Of course, all else being equal, higher earnings should translate into a higher stock price. One can easily imagine, however, that over time high earnings could become a goal in and of itself.

These final two points are related. A large majority of respondents in a recent survey of over 400 financial executives stated that meeting quarterly earnings targets helps to maintain or increase stock prices.[67] The CFOs apparently believe that, at least in the short run, stock analysts punish firms that fail to deliver promised earnings.[68] The executives had a rational explanation for this effect—because all firms manage earnings to some extent and typically have sufficient reserves to achieve their earnings targets, failure to do so suggests hidden problems at the firm or poor management.[69] But the more important point is that managers link short-term stock performance and reported earnings.[70]

There are no obvious reasons why managers would have *less* of an appetite than shareholders for earnings, or at least no systematic reasons.[71] At

---

text.

66. Of course, some shareholders may take this view as well. Thus, references to the "shareholders'" appetite for earnings should be read as the preferences of sophisticated long-term investors.

67. *See* Graham et al., *supra* note 38, at tbl.4 (finding that 82% of respondents agreed or strongly agreed with this statement).

68. *Id.* at 26.

69. *Id.* at 13.

70. *Id.* at 15.

71. Depending on bonus plan structure, managers may have an incentive to reduce reported earnings in a particular period. Imagine that a manager's annual bonus opportunity is dependent on company earnings exceeding a particular threshold and that it becomes obvious that the threshold will not be exceeded for year X. In that case, the manager has an incentive to accelerate expenses from year X+1 to year X. Taking a "big bath" in year X will have no impact

times, accounting results may provide an excuse or cover for managers to achieve other objectives, and excuses may be predicated on earnings-decreasing changes in accounting. For example, a 1990 change in accounting for post-retirement health care benefits resulted in a substantial increase in reported expenses.[72] The implementation of this change was followed by massive cuts in these benefits. The accounting change may have provided the political cover needed to implement these cuts. However, this Machiavellian story is undermined by the observation that managers vociferously opposed the adoption of this accounting standard.[73] Moreover, the excuse theory works both ways. As noted above, managerial resistance to stock option expensing, an earnings-decreasing change, may have arisen in part from a desire to minimize the salience of managerial compensation.

Given the directional ambiguity of the accounting-as-excuse story and all the other reasons for managers to have a stronger appetite than shareholders for earnings, we should expect the distribution of managerial preferences along the continuum between maximizing reported earnings and maximizing other cash flows to be shifted in the direction of earnings maximization, relative to shareholder preferences. Assuming a divergence between shareholder and manager preferences, how do firms respond in situations in which earnings and cash flow concerns conflict? The resolution depends on the severity of the managerial agency problem in any given firm, which is a function of incentives and corporate governance.[74] Perversely, managers of firms that have more closely linked executive pay to earnings in order to align managerial incentives with those of shareholders are more likely to sacrifice cash flow for reported earnings.[75] But among firms with similar pay practices, we should expect

---

on her bonus for that year, but will increase the likelihood of exceeding the earnings threshold and receiving a bonus for year X+1. *See generally* Timothy W. Koch & Larry D. Wall, *The Use of Accruals to Manage Reported Earnings: Theory and Evidence* (Fed. Reserve Bank of Atlanta, Working Paper No. 2000-23, 2000). Note, however, that the "big bath" phenomenon does not suggest that managers would prefer earnings-reducing accounting standard changes. Generally, managers prefer to report high earnings.

72. *Infra* notes 76–79 and accompanying text.

73. *See* Stephen A. Zeff, *The Evolution of U.S. GAAP: The Political Forces Behind the Professional Standards*, CPA J., Feb. 2005, at 18, 25–26 (recounting strong opposition by industry to this change in accounting standards but noting that "afterwards, companies conceded its constructive effect on their decision making").

74. Jensen & Meckling, *supra* note 63, at 328–29. *See generally* Bebchuk et al., *supra* note 61.

75. This phenomenon demonstrates the intractability of the managerial agency problem. As with the arcade game "Whac-a-Mole," efforts to combat shirking, excessive perquisite consumption, and similar agency problems by tying executive pay to financial results can result in unexpected agency problems popping up elsewhere.

better governed firms to more closely track shareholder preferences and exhibit relatively less appetite for earnings relative to more poorly governed firms. In fact, one can imagine that, in many cases, shareholder preferences for earnings per se are negligible, while managerial preferences are considerable, leading to quite different earnings management behavior between well and poorly governed firms. I am not aware of any empirical evidence on this point, and it seems fertile ground for further research. We turn now, however, to consider empirical evidence on the general topic of the behavioral impact of financial accounting.

III. Empirical Evidence on Accounting, Share Value, and Corporate Behavior

The empirical evidence establishes that accounting standards and practices matter. Accounting choices vary systematically between firms; corporations make operational changes in response to adjustments in accounting rules, and firms sacrifice cash flows to boost reported earnings. Unfortunately, the empirical evidence does a poorer job of explaining *why* accounting matters. Some of the evidence supports the detailed predictions of the share value enhancing aspects of positive accounting theory, but much of the evidence is as consistent with a manager-driven theory of accounting choice. None of this evidence is inconsistent with the semi-strong view of the ECMH.

A. Stock Price Reaction to Changes in Mandatory Accounting Standards

The most obvious place to begin in a search for economic effects of accounting is with changes in mandatory standards and market reaction to those changes, and indeed, some studies have found stock price reactions to changes in standards. For example, in 1990, the FASB implemented Statement of Financial Accounting Standards No. 106 (SFAS 106),[76] which replaced pay-as-you-go accounting for post-retirement health care benefits with accrual accounting.[77] This shift reduced reported earnings for companies offering such benefits. One study of SFAS 106 implementation found that the release of the exposure draft document formally proposing the standard change resulted in a

---

76. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 106, EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS (Dec. 1990) [hereinafter SFAS No. 106].

77. Espahbodi et al., *supra* note 45, at 336–37.

3% share price reduction for the firms in their sample.[78] This result appears to provide evidence for the contracting cost hypothesis and specifically the debt covenant hypothesis: Reduced earnings as a result of SFAS 106 implementation would increase the risk of costly default.[79]

By contrast, a study of share price reaction to several key FASB announcements pertaining to stock option expensing found no evidence of systematic market reaction to these announcements.[80] Expensing of stock options would reduce reported earnings and result in a stock price decrease if the debt covenant effect were dominant. Thus, announcements signaling an increasing/decreasing likelihood of expensing should have resulted in reduced/increased share prices.

In their 1986 book on positive accounting theory, Watts and Zimmerman report that studies investigating stock price reactions to mandated changes in accounting procedures support the theory, but they admit that the associations between variables are inconsistent across studies.[81] A more recent survey reviewing twenty-six studies of mandated accounting changes published in the top three accounting journals during the 1980s concluded that in aggregate these studies provided little or no evidence of stock price effects. The author concluded that the effects were small.[82] It is also possible, however, that the effects are significant but are often undetected because of the difficulty of isolating accounting change announcements that surprise the market.[83]

---

78. *Id.* at 341. Sample firms offering post-retirement benefits experienced a 3% abnormal negative return compared to a control group of firms not offering such benefits. *Id.* at 340 tbl.4. The authors also found that the negative impact of the new standard on stock prices varied cross-sectionally, as expected; the effect was more pronounced for firms that were at greater risk of default as evidenced by high debt to equity ratios. *Id.* at 343.

79. *Id.* at 326. The authors also speculated that SFAS 106 may have increased contracting costs generally, by making a poor tradeoff between timeliness and reliability of information provided to the marketplace. *Id.* at 327. Accrual accounting is more timely than pay-as-you-go, but accrual accounting involves estimation that was not necessary under the former standard.

80. Dechow et al., *supra* note 10, at 16. The events tested were the 1993 announcement that the FASB had voted to mandate stock option expensing, the release of the exposure draft mandating expensing about three months later, and the subsequent announcement that the FASB would drop mandatory expensing in favor of voluntary expensing and mandatory footnoting. *Id.* at 18 tbl.4. The study did find significant management reaction to the expensing proposal in the form of comment letters to the SEC objecting to option expensing. *Id.* at 16.

81. WATTS & ZIMMERMAN, *supra* note 13, at 311.

82. V.L. Bernard, *Capital Markets Research in Accounting During the 1980s: A Critical Review, from the State of Accounting Research as We Enter the 1990s*, Bd. of Trustees of the Univ. of Ill., Champaign (1989) (cited in Fields, *supra* note 22, at 264).

83. Leftwich, *supra* note 47, at 10. For this reason, Watts and Zimmerman note that stock price change studies are relatively weak tests of positive accounting theory. Watts & Zimmerman, *supra* note 13, at 138. If one accepts at least the semi-strong version of the

It is worth noting, however, that there is no evidence that the *implementation* of an accounting standard change impacts stock prices. Researchers investigating SFAS 106 implementation, for example, generally agree that the market had fully incorporated the change into stock prices prior to implementation.[84] This evidence is consistent with semi-strong market efficiency. Under a naïve investor view of the market, stock prices should have been reduced on the promulgation of earnings statements applying the new standard.

B. Corporate Response to Changes in Mandatory Accounting Standards

Given the difficulty of isolating share price responses to accounting standard changes, some studies have focused, instead, on corporate reaction to these changes. These studies reinforce the view that accounting matters and provide limited support for the positive accounting theory explanation.

For example, SFAS 106, which engineered the switch from pay-as-you-go accounting for post-retirement health care benefits to accrual accounting, had a dramatic effect on firm behavior. Companies reacted to the new standard by slashing post-retirement health care benefits.[85] One study of SFAS 106 implementation found a tight cluster of benefit cuts around the adoption date

---

ECMH, the actual reporting of higher or lower earnings as a result of a change in an accounting standard that has no impact on the supply of publicly available information should have no effect on stock prices. The market sees through this. The effect on firm value and stock price arises from sticky contracts and the effect of a change in reported earnings on those contracts. Once the market gets wind of a coming change in standards, however, the market can predict the impact of that change on contracting costs in advance of its implementation. Holthausen & Leftwich, *supra* note 39, at 105–06. Thus, assuming that a standard change is merely cosmetic, the impact of the coming change should be fully incorporated in stock prices when the market becomes confident that the change will be implemented. As a result, researchers looking for evidence of market reaction to accounting changes focus on FASB exposure drafts or other announcements of proposed changes. *Id.* at 105. But a price effect would be expected only when the market is surprised. Accounting standard changes that are suggested, debated, announced, revised, and re-announced may not result in the degree of surprise that would result in a statistically significant stock price change even if the effect on contracting costs is significant. *Id.* at 106.

84. *See* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 66 (2003) (summarizing studies); *see also* H. Fred Mittelstaedt et al., *SFAS No. 106 and Benefit Reductions in Employer-Sponsored Retiree Health Care Plans*, 70 ACCT. REV. 535, 538 (1995) (asking "why managers reduce[d] benefits as a result of SFAS No. 106 if security prices fully reflect[ed] retiree health care liabilities prior to its adoption").

85. Mittelstaedt et al., *supra* note 84, at 548 tbl.2. *See also id.* at 554 (concluding that 89% of firms cut retiree health care benefits shortly after the adoption of SFAS 106).

following ten years in which cuts were rare[86] and concluded that the "data indicate a strong associative relation between the decision to cut retiree health care benefits and the requirement to adopt SFAS No. 106."[87]

The authors of that study also found evidence supportive of the contracting cost hypothesis. They found that cuts in benefits were related to the extent to which a firm was leveraged prior to the adoption of SFAS 106 (a proxy for the tightness of debt covenants) and the extent to which adoption increased that leverage (which proxied for the increased risk of covenant violation).[88]

However, as suggested above, some observers believe that the relationship between the promulgation of SFAS 106 and benefit cuts is better explained as political cover.[89] Accrual accounting for these benefits massively increased the expense reported in company financial statements and allowed companies slashing benefits to place the blame on the accountants.[90] Thus, it is difficult to determine the relative contributions of contracting costs, political cover, and managerial fixation with reported earnings towards the clear corporate behavioral response to SFAS 106.

Similar results were found in an earlier study that investigated corporate response to SFAS 13, which moved capital lease disclosures from financial statement footnotes onto corporate balance sheets.[91] That move had the effect of increasing debt and reducing reported income, which increased leverage and decreased reported rates of return.[92] From either a debt covenant or managerial compensation perspective, this was an unwelcome change. Increased leverage increased the risk of debt covenant default, and managerial compensation often is tied, implicitly or explicitly, to accounting rates of return.[93] Thus, the authors

86. *Id.* at 548 tbl.2.

87. *Id.* at 554. Of course, we need to be concerned about causation and potential omitted variable problems. *See* Ray Ball, *Discussion of Accounting for Research and Development Costs: The Impact on Research and Development Expenditures*, 18 J. ACCT. RES. 27, 37 (1980) (warning that accounting change studies are suspect because they treat the imposition of a new standard as exogenous, when in fact, the new standard, corporate reaction, and stock price changes all may be related to an omitted environmental change).

88. *Id.* at 542–43.

89. *Supra* note 73 and accompanying text.

90. *See* Mittelstaedt et al., *supra* note 84, at 538–39 (reporting that employers testifying before Congress blamed the cutting of retiree health care benefits in part on SFAS 106).

91. For a detailed discussion of the changes after SFAS No. 13, see Eugene A. Imhoff, Jr. & Jacob K. Thomas, *Economic Consequences of Accounting Standards: The Lease Disclosure Rule Change*, 10 J. ACCT. & ECON. 277 (1988).

92. *Id.* at 279.

93. *Id.* at 279–81.

predicted (and found) that firms would respond by reducing their reliance on capital leases and shifting to operating leases that had better accounting characteristics.[94] Although the authors demonstrated corporate sensitivity to the negative accounting standard change, they did not test for the positive accounting theory explanations.

C. Stock Option Expense Accounting

Of course, the highest profile change in accounting standards to occur in some time was the adoption of mandatory stock option expensing, which came into effect in 2005 and 2006.[95] Many experts predict that this change will result in a significant adjustment in compensation practices. However, a study of corporate lobbying against the rule's adoption indicates that opposition was driven by management concerns unrelated to real economic effects.[96] But before turning to this study, let us consider the behavioral effects of the previous accounting regime.

Until 2005, standard compensatory stock options resulted in no reduction in reported earnings at grant, exercise, or any other time, although the compensation expense has been reported in footnotes to earnings statements since 1995.[97] Anecdotal and empirical evidence suggest that this anomalous accounting treatment was a primary factor in the growing use of options in the 1990s. Less clear, however, is whether share value enhancing aspects of positive accounting theory or self-serving managerial behavior better explains the incentive effect of stock option accounting.

---

94. *See id.* at 278 (finding the substitution of capital leases for operating leases to be the most "pervasive effect" of SFAS No. 13).

95. Companies (other than small businesses) are required to record option compensation as an expense in fiscal years beginning on or after June 15, 2005. 17 C.F.R. § 210.4-01(a)(3)(i)(A) (2007) (codifying Exchange Act Release No. 33-8568 (Apr. 21, 2005)). Thus, a company with a fiscal year beginning on June 1 would not have been required to report option compensation as an expense until late in 2006.

96. *See* Dechow et al., *supra* note 10, at 16 (finding no evidence that lobbying was motivated by the cost of capital or the cost of contracting).

97. *See* ACCOUNTING PRINCIPLES BD., OPINION NO. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES (1972), *reprinted in* OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD 467, 470–71 (1972) (establishing what became known as the "intrinsic value" method of accounting for option compensation); SFAS No.123, *supra* note 29, at para. 1–5 (encouraging adoption of "fair value" accounting for stock options and requiring pro forma disclosure of expense by firms continuing to apply APB 25); SFAS No. 123R, *supra* note 7, at para. 1–3 (mandating "fair value" accounting for options); *see also* Judith E. Alden & Murray S. Akresh, *Using Equity to Compensate Executives*, *in* EXECUTIVE COMPENSATION, *supra* note 55, at 67, 102–04 (describing accounting rules for stock options).

Practitioners and practice-oriented academics are uniformly of the view that the accounting treatment of stock options is important to executives and that the favorable treatment under pre-2005 GAAP contributed to the explosion in their use. Kevin Murphy, a financial economist and noted executive compensation expert, argues that the increased prevalence in the 1990s of broad-based stock option plans granting a majority of options to employees below the very top ranks is evidence of option overuse because only the top executives are in position to significantly influence a firm's stock price.[98] Murphy attributes excessive use of options to management misperception that options represented inexpensive compensation.[99] That misperception was based on the fact that options required no cash outlay (although that was also true of stock compensation, which was far less popular) and on the fact that, until recently, options did not reduce reported earnings.[100] Murphy does not believe that the accounting treatment of options had a direct effect on share prices or that management fixation on compensation accounting was based solely on share price effects.[101] "[B]ased on countless discussions (often heated arguments) with compensation consultants, practitioners, and executives, [Murphy is] convinced that . . . this fixation reflects more than the effect of accounting rules on stock prices."[102]

Murphy believes that "companies . . . respond . . . dramatically to changes in the accounting treatment of stock options."[103] As evidence, Murphy cites data demonstrating that the practice of explicitly reducing the exercise prices of outstanding stock options following market downturns came to an abrupt halt at the end of 1998 when new accounting rules required firms to expense repriced options.[104] Similarly, Brian Hall and Jeff Liebman echo the view of practitioners that accounting treatment is an important factor in option plan design.[105] They report that companies often fail to seriously consider stock

---

98. Murphy, *supra* note 9, at 857–58.

99. *Id.* at 859; *see also* Hall & Murphy, *supra* note 84, at 66 (arguing that the result of underestimating the true cost of stock options "is that too many options will be granted to too many people, and options with favorable accounting treatment will be preferred to (perhaps better) incentive plans with less favorable accounting").

100. Murphy, *supra* note 9, at 859–60.

101. *Id.* at 860.

102. *Id.*

103. *Id.*

104. *Id.* at 861–62.

105. Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation* 6 (Nat'l Bureau of Econ. Research, Working Paper No. 7596, 2000), *available at* http://ssrn.com/abstract=220848.

option plans that had "bad accounting," i.e., result in compensation expense recognition.[106]

Although somewhat mixed, there is a growing body of empirical evidence linking stock option use to its once-favorable accounting treatment. Because the accounting treatment of conventional stock options was consistent up to 2005, cross-sectional analyses have been employed in seeking to establish a relationship between option use and the degree to which companies were concerned with financial reporting results.[107]

Of three studies focusing exclusively on option grants to CEOs, only one found significant evidence that accounting drove option use.[108] However, two studies of broad-based option plans both reached that conclusion. First, an analysis of all options granted to employees by 123 firms over an eleven year period found a positive relationship between the use of options and other earnings management techniques and between option use and dividend constraints.[109] And a more recent examination of option grants to executives reported in the Standard & Poor's ExecuComp database yielded the conclusion "that what was driving the use of options in non-CEO compensation [was] *not* the need to realign incentives, but the desire to avoid the expense."[110]

Although CEOs typically receive the largest option grants within their companies, CEO options typically represent a small percentage of total options

106. *Id.*

107. As the studies discussed in the text and notes that follow exemplify, sensitivity to reported earnings sometimes is estimated directly by looking at variables such as interest coverage or retained earnings. Low interest coverage increases the probability of violating debt covenants and limited retained earnings are likely to result in dividend constraints. These variables are consistent with positive accounting theory and specifically the debt covenant hypothesis. Other studies determine earnings sensitivity indirectly by looking for other evidence of earnings management, such as how consistently a firm beats analyst earnings forecasts. Although these latter studies tell us something about earnings sensitivity, they tell us little about positive accounting theory. Earnings sensitivity in these cases could be driven by self-serving managerial behavior rather than share value maximization.

108. *Compare* John Core & Wayne Guay, *The Use of Equity Grants to Manage Optimal Equity Incentive Levels*, 28 J. ACCT. & ECON. 151, 173 (1999) (finding a significant and positive relationship between option use and dividend constraints), *with* David Yermack, *Do Corporations Award CEO Stock Options Effectively?*, 39 J. FIN. ECON. 237, 264 (1995) (finding no significant relationship between option use and financial reporting costs), *and* Stephen Bryan et al., *CEO Stock-Based Compensation: An Empirical Analysis on Incentive-Intensity, Relative Mix, and Economic Determinants*, 73 J. BUS. 661, 683 (2000) (finding evidence of a significant link between options use and some measures of financial reporting costs, but not others).

109. Steven R. Matsunaga, *The Effects of Financial Reporting Costs on the Use of Employee Stock Options*, 70 ACCT. REV. 1, 23 (1995).

110. Mary Ellen Carter et al., *The Role of Accounting in the Design of CEO Equity Compensation*, 82 ACCT. REV. 327, 355 (2007).

granted.[111] Accordingly, the earnings effect of CEO options alone would be small in comparison to the effect of paying employees with options generally, and it is not surprising that studies looking at broad-based option plans are more informative.

Of course, the ultimate test of the impact of option accounting on option use will be in the response of companies to the new option expensing requirement. Already, there is evidence of a shift away from options in favor of other forms of equity compensation, such as restricted stock, but it is too early to draw firm conclusions.[112]

The evidence suggests that the pre-2005 stock option accounting rules served as a successful, although unintended, accounting incentive. The next question is whether responsiveness to that incentive reflected contracting costs and the shareholders' interest or was driven by managerial interests. Lawrence Brown and Yen-Jung Lee provide evidence indicating the latter.[113] They find an association between reduced use of options subsequent to the change in accounting rules and improved operating performance.[114] This evidence suggests that the use of options under the prior accounting regime reduced shareholder value.[115]

Moreover, there is an additional reason to suspect that self-serving managerial behavior played an important role in the use of options under the pre-2005 accounting regime. Managers may care excessively about reported earnings generally, but even if they do not, they might prefer that stock options not be expensed (and might over-rely on options given the pre-2005 accounting treatment) because "footnoting" option compensation helped to camouflage their own compensation.

---

111. *See, e.g.*, Hall & Murphy, *supra* note 84, at 51 (finding that the value of options granted to CEOs of S&P 500 firms averaged about 7% of the total value of options granted in the mid-1990s and fell to less than 5% from 2000 to 2002).

112. *See* Michael S. Knoll, *Restricted Stock and the Section 83(b) Election: A Joint Tax Perspective* 2 (U. Penn. Inst. for Law & Econ. Research, Working Paper No. 05-26, 2005), *available at* http://ssrn.com/abstract=795544 (citing survey evidence indicating a shift from stock options to restricted stock); Lawrence D. Brown & Yen-Jung Lee, The Impact of SFAS 123R on Changes in Option-Based Compensation 23, 33 (May 2007) (unpublished working paper, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=930818 (finding that for a sample of about 750 firms, options represented 42% of executive compensation pre-SFAS 123R but only 29% post-SFAS 123R). However, the reduction in reliance on options may have been attributable to a number of factors, including the fallout of recent corporate scandals, in addition to the change in accounting rules. *Id.*

113. *See generally* Brown & Lee, *supra* note 112 (analyzing changes in the composition of executive compensation post-SFAS 123R).

114. *See id.* at 30 (describing the results of regression analysis).

115. *Id.* at 5.

Two colleagues and I have argued that U.S. executive compensation practices reflect, in large part, a managerial power view of corporate governance.[116] Under this theory, executive compensation is not set by efficient contracting, but is largely controlled by the managers, subject to market forces and to investor and financial press outrage that tends to constrain directors and the managers themselves.[117] Compensation transparency is the manager's enemy according to this view, and compensation channels that are less visible or camouflaged will be preferred.[118]

There is some evidence that accounting camouflage plays a role in stock option use. Although options are often granted far down into the employee ranks, the value of options often is concentrated at the very top. One study found evidence that corporate opposition to the 1993 FASB proposal to mandate stock option expensing was driven by top executives' concerns relating to the scrutiny of their compensation and not by real economic effects.[119] Specifically, the study found that top executives of companies submitting comment letters to the FASB opposing the change tended to receive a greater fraction of their total pay through options and more pay in total than executives of similar noncommenting firms.[120] In addition, it found that option programs were more "top heavy" in commenting firms relative to their noncommenting peers.[121] This evidence suggests that the stock option accounting "incentive" may have been more effective than simple earnings fixation would imply.

D. *Voluntary Accounting Choice Evidence—Tax/Earnings Tradeoffs*

Every day, managers make choices between permissible accounting techniques and make operational decisions that have significant accounting consequences. The choice to employ stock options in lieu of other forms of compensation provides one example of voluntary accounting choice writ large. Studies of voluntary accounting choices demonstrate that accounting is not irrelevant. This literature is voluminous. Instead of attempting to provide an overview, I will direct the reader to any of several good survey articles noted in

116. Bebchuk et al., *supra* note 61, at 846; BEBCHUK & FRIED, *supra* note 61, at 61–79.

117. Bebchuk et al., *supra* note 61, at 786–88.

118. *Id.* at 789.

119. Dechow et al., *supra* note 10, at 2.

120. *Id.*

121. *See id.* (finding that, compared with their peers, commenting firms "use[d] options relatively more intensively for top-executive compensation than for other employees").

the margin,[122] and focus here, by way of example, on the literature examining the tradeoff between minimizing taxes and boosting reported earnings.

This literature is typical of voluntary accounting choice studies. One review study summed up the evidence as follows: "In short, the literature suggests that financial accounting management and tax management are not independent and neither consideration consistently dominates the other in decision-making."[123] In other words, to a greater or lesser extent, managers trade off taxes for earnings.

1. Discrete, One-Time Events

Although financial and tax accounting rules differ in many respects, managers often face a conflict between minimizing taxes and maximizing earnings. Actions that reduce taxable income and taxes often result in lower financial statement income as well. If accounting were irrelevant, we would expect managers to ignore reported earnings and minimize taxes in order to maximize after-tax cash flow. Instead, we often see managers sacrificing cash flow for reported earnings improvements. Many examples involve discrete, one-time events.

The *Kamin* case, discussed above, is a prime example. There, recall, the directors apparently forwent potential tax savings of $8 million to avoid a $26 million reduction in reported earnings.[124] The decision to distribute the depreciated securities to the shareholders rather than sell them and distribute the cash proceeds in *Kamin* apparently had no other consequence for shareholders.

If the facts are taken as given in the opinion, the *Kamin* case squarely presents a tradeoff between tax savings and earnings management.[125] Although

122. *See generally* Fields et al., *supra* note 22; Douglas A. Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, 31 J. ACCT. & ECON. 321 (2001).

123. Shackelford & Shevlin, *supra* note 122, at 327.

124. Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 809–10 (Sup. Ct. 1976).

125. We should be careful not to read too much into this example. First, the case was decided on a summary judgment motion made by the American Express defendants, which required the judge to accept the facts as presented by the plaintiffs. Normally, we should be highly suspicious of the facts presented in this circumstance. However, the opinion suggests that the minutes of the relevant directors' meeting essentially confirmed the facts alleged by the plaintiffs. *Id.* at 811. Second, this is a single isolated case. Nonetheless, practitioners generally are not surprised by the action of the American Express board in this case and find it consistent with their experience. *See, e.g.*, *Conversations from the Warren Buffet Symposium* (Lawrence A. Cunningham, ed.), 19 CARDOZO L. REV. 719, 794–800 (1997) (discussing *Kamin* and more egregious examples of the phenomenon). *Kamin* is also consistent with empirical studies of

somewhat less clean, two empirical studies of asset divestitures support the view that managers sacrifice tax benefits and cash flow to boost earnings when disposing of assets, but these studies provide only limited support for positive accounting theory. One study investigated taxable sales versus nontaxable spin-offs of corporate subsidiaries.[126] Just as the American Express directors faced a choice between selling the depreciated securities and distributing them to shareholders, directors of a company wishing to dispose of a subsidiary can sell it or distribute its stock to shareholders through a nontaxable spin-off.[127] If managers focused solely on tax minimization, they would spin-off subsidiaries if a sale would result in a taxable gain and sell subsidiaries if a sale would result in a tax loss. Instead, this study demonstrated that managers routinely incurred avoidable tax costs or forwent potential tax benefits in structuring divestments.[128]

Of course, there could be many reasons other than tax and financial reporting considerations for structuring a divestment as a sale or spin-off—a sale generates cash, while a spin-off does not; a sale may yield a premium price if the asset is worth more in the hands of the buyer.[129] Nonetheless, the evidence was consistent with the view that managers trade off tax against earnings, and the authors estimated that firms were willing to incur \$0.19 of extra tax costs to boost earnings by \$1.00.[130] This study provided little evidence of positive accounting theory. The results were only "weakly consistent" with contracting cost variables.[131]

Another study of major asset divestitures confirms that managers weigh both taxes and the impact on reported income in making divestitures.[132] This study found that firms with greater inside ownership concentration were less likely to sacrifice tax benefits in an effort to boost reported earnings.[133] The author suggested that high inside ownership concentration reduces capital

---

asset divestitures, as discussed below. *Infra* notes 126–34 and accompanying text.

126. Edward L. Maydew et al., *The Impact of Taxes on the Choice of Divestiture Method*, 28 J. ACCT. & ECON. 117 (1999).

127. In a properly designed spin-off transaction, the parent company recognizes no gain or loss and shareholders face no immediate tax consequences; rather, a shareholder's basis in parent stock is reallocated between the stock received in the spin-off firm and the stock maintained in the now smaller parent firm. *Id.* at 121.

128. *Id.* at 120.

129. *Id.* at 119–20.

130. *Id.* at 146.

131. *Id.* at 138.

132. Kenneth J. Klassen, *The Impact of Inside Ownership Concentration on the Trade-Off Between Financial and Tax Reporting*, 72 ACCT. REV. 455 (1997).

133. *Id.* at 472.

market pressures on a firm.[134] That may be so, but it is unclear how this reduced capital market pressure fits into positive accounting theory. That theory holds that shareholders are sensitive to earnings because of sticky contracts based on those earnings. Perhaps high inside ownership concentration reduces the cost of renegotiating executive compensation contracts, but it is unclear what effect inside ownership would have on debt covenants. It seems much more plausible that firms with high inside ownership focus more on after-tax cash flow because manager and shareholder interests are more closely aligned. This evidence supports the view that the appetite for earnings found in many of these studies is driven by managerial preferences rather than or in addition to shareholder preferences.

2. *Ongoing Activities*

Kamin and the asset disposition studies certainly demonstrate management sensitivity to reported earnings. But these cases involve major, one-time events. One may question whether earnings effects influence corporate behavior with respect to more mundane day-to-day operational or accounting decisions. Apparently they do, but perhaps less consistently or to a lesser extent. Again, rather than reviewing a large sample of studies, I will focus on two examples and leave the interested reader to peruse the review studies cited in the notes.[135]

The first example involves disqualification of incentive stock options (ISOs). The ISO disqualification evidence is consistent with what we have seen before—accounting matters—but the evidence does not clearly distinguish between share value enhancing and manager-driven explanations of accounting relevance.

Compared with nonqualified stock options, ISOs provide tax benefits for optionees, but result in tax costs for issuers.[136] In some cases, depending on various tax rates and the amount of appreciation in the stock underlying the ISO, it makes economic sense for companies and employees to agree to arrange dispositions that will disqualify options for ISO treatment.[137] At times, the tax benefit to a company from disqualification is more than sufficient to reimburse

134. *Id.*

135. In addition to Shackelford & Shevlin, *supra* note 122, useful reviews of this literature can be found in MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH (2d ed. 2002), Fields et al., *supra* note 22, and Maydew et al., *supra* note 126.

136. SCHOLES ET AL., *supra* note 135, at 191–92.

137. *Id.* at 196–97.

an employee for her additional tax cost. This reimbursement, however, must be recognized as an expense, which reduces reported income.[138]

Matsunaga, Shevlin, and Shores investigated ISO exercise and disqualification by 170 companies between 1982 and 1991 and estimated whether disqualification would have resulted in a net tax benefit for the companies and their employees.[139] The authors determined that in over half of the cases in which there was a net tax benefit, firms failed to disqualify options.[140] The authors concluded that firms trade off tax benefits against reported earnings.[141] Cross-sectional analysis of firms that did and did not disqualify ISOs yielded some evidence supporting positive accounting theory. The net tax benefit tended to be larger when options were disqualified; and nondisqualifying firms tended to be more highly leveraged, and thus would have faced higher debt covenant costs had they disqualified their ISOs.[142]

The second example of tradeoffs between taxes and earnings in day-to-day operations involves inventory accounting. Under current tax rules, companies may value inventory under either a "first in, first out" (FIFO) approach, in which case the value of inventory tends to approximate current costs, or a "last-in, first-out" (LIFO) approach, in which case historic inventory values tend to persist.[143] However, companies electing to use the LIFO approach for tax purposes are required to use the same approach to valuing inventories in preparing the accounts presented to investors.[144] In a period of rising prices, LIFO inventory valuation results in less taxable income than FIFO valuation.[145]

---

138. *Id.* at 197.

139. Steve Matsunaga et al., *Disqualifying Dispositions of Incentive Stock Options: Tax Benefits Versus Financial Reporting Costs*, 30 J. ACCT. RES. 37, 50–52 (1992).

140. *Id.* at 63 tbl.6.

141. *Id.* at 66.

142. *Id.* at 63 tbl.6.

143. *See* 26 C.F.R. § 1.472-1 (2007) (allowing for election of the LIFO accounting method for inventories).

144. I.R.C. § 472(c) (Supp. IV 2005).

145. In determining taxable income, businesses that buy and sell inventory first calculate gross profit as follows:

Gross Profit = Receipts – Cost of Goods Sold (COGS)

COGS = Value of Opening Inventory + Inventory Purchased – Value of Closing Inventory

Compared with FIFO, LIFO results in reduced gross profit and taxable income during inflationary periods because LIFO results in a relatively lower closing inventory valuation and a relatively greater cost of goods sold. *See* I.R.C. §§ 471, 472 (providing the statutory requirements for LIFO inventory accounting); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 750–54 (5th ed. 2005) (explaining the effect of inventory valuation methodology on taxes and earnings).

But LIFO valuation also results in reduced reported earnings in inflationary times. Thus, firms face a tradeoff between minimizing taxes and maximizing reported earnings when they choose between LIFO and FIFO accounting.[146]

Conventional wisdom has held that firms often failed to adopt LIFO, leaving potential tax savings on the table, because they preferred the financial accounting effects of FIFO.[147] Two studies produced in the late 1980s and early 1990s found that tax savings were an important factor in firms' LIFO/FIFO decisions, but they did not show that earnings preferences were unimportant. Examining a sample of large publicly traded firms consistently using LIFO or FIFO as their primary inventory method between 1962 and 1981, Dopuch and Pincus found that the median LIFO firm saved $942,000 per year as a result of using LIFO and that the median FIFO firm sacrificed $160,000 per year as a result of its failure to adopt LIFO.[148] The authors concluded that this data was consistent with a tax motivation for adopting LIFO, suggesting that the tax savings forgone by FIFO firms were too small to justify the administrative costs of switching.[149] Although that conclusion is plausible and supports the idea the firms grow into LIFO,[150] it is also possible that a significant number of the FIFO firms would have switched to LIFO absent the adverse effect on earnings.

A 1992 study by Cushing and LeClere included survey evidence on firm motivation in choosing LIFO or FIFO.[151] With respect to 27% of the FIFO firms responding, the authors "could not identify any convincing explanation for the continuing use of FIFO."[152] In a response that undermines Dopuch and

146. Companies adopting LIFO inventory accounting (in full or in part) for purposes of computing their primary earnings figures can include in the footnotes to their financial reports pro forma earnings calculations utilizing FIFO accounting. Kleinbard, Plesko, and Goodman argue that this option is widely employed and renders book-tax inventory accounting conformity illusory. Edward D. Kleinbard et al., *Is it Time to Liquidate LIFO?*, 113 TAX NOTES 237, (2006). But if the distinction between primary and pro forma earnings figures were unimportant, it is doubtful that managers would have resisted the FASB's efforts to move stock option expense from footnote to primary earnings statement. Of course, specific differences between inventory and stock option compensation accounting could exist that explain this apparent paradox.

147. *See* DEPT. OF TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 111 (1984) (noting that roughly 95% of firms with inventories used FIFO accounting).

148. Nicholas Dopuch & Morton Pincus, *Evidence on the Choice of Inventory Accounting Methods: LIFO Versus FIFO*, 26 J. ACCT. RES. 28, 36–37 (1988).

149. *Id.* at 37.

150. In the authors' sample, the median FIFO firm was about one-tenth the size of the median LIFO firm. *Id.* at 36.

151. Barry E. Cushing & Marc J. LeClere, *Evidence on the Determinants of Inventory Accounting Policy Choice*, 67 ACCT. REV. 355 (1992).

152. *Id.* at 364.

Pincus' inference from their study, only 6% of FIFO users reported that LIFO bookkeeping costs were the most important reason they used FIFO and 44% rated this factor as unimportant or irrelevant.[153]

Moreover, in arguing for the repeal of the LIFO tax option, Kleinbard, Plesko, and Goodman have recently shown that LIFO use peaked in the early 1980s and is quite rare today.[154] They found that fewer than 10% of U.S. public companies with inventories reported having a LIFO reserve in 2005 and that less than 2% of firms used LIFO exclusively.[155] Further, they found that LIFO use was highly concentrated, with thirteen companies accounting for 50% of LIFO reserves and fifty-six companies accounting for 80% of LIFO reserves in 2004.[156]

Of course, this data does not tell us that the remaining firms with inventories are sacrificing significant tax benefits by forsaking LIFO. Certainly, the inflationary driving force for LIFO adoption has been modest in recent years. On the other hand, one would suspect that bookkeeping costs per revenue dollar have fallen since the 1970s and 1980s as a result of automation.

The LIFO/FIFO evidence does not establish that firms ignore earnings in selecting an inventory methodology. Moreover, the fact that tax appears to be an important consideration in the choice of inventory methodology is not inconsistent with the view that firms tradeoff taxes for earnings. That view does not suggest that firms ignore taxes, only that the earnings considerations result in less tax minimization than would occur in their absence. However, this evidence might suggest that firms do a better job of ignoring earnings and maximizing cash flows with respect to decisions with continuing impact, such

---

153. *Id.* at 363 tbl.4.

154. Kleinbard et al., *supra* note 146, at 249.

155. *Id.*

156. *Id.* at 251. Combining the Kleinbard, Plesko, and Goodman data with that provided in a recent Wall Street Journal article allows one to estimate that Exxon Mobil Corporation alone accounts for about 20% of recent LIFO reserves of U.S. public companies. *See id.* at 238 (stating that the total LIFO reserves in 2005 were almost $70 billion); David Reilly, *Big Oil's Accounting Methods Fuel Criticism*, WALL ST. J., Aug. 8, 2006, at C1 (reporting that Exxon's LIFO reserves in 2005 were $15.4 billion). U.S. oil companies generally use LIFO inventory accounting. *Id.* at C1. For these companies, LIFO may provide advantages for both tax and earnings purposes. The profits of the oil majors are very sensitive to world oil prices. When crude oil prices rise, gasoline pump prices rise, as do the profits of the oil majors, inevitably leading to price gouging investigations and calls for the imposition of windfall profits taxes on the oil companies. The negative political costs of high reported earnings arising from oil price jumps may outweigh other contracting costs as well as the oil executives' general preferences for high reported earnings. By holding down both reported earnings and taxable income in a period of rising oil prices, LIFO may be unambiguously positive for the oil majors.

as choice of inventory methodology, than discrete, one-time events, such as asset dispositions.

3. *Taxes Paid on Fraudulent Earnings*

As a final egregious example of companies sacrificing taxes for earnings, consider a recent study of firms that restated financial statements between 1996 and 2002 as a result of SEC accusations of accounting fraud.[157] This study found that the mean firm paid $11.85 million in taxes on the phantom earnings, or about $0.11 for each dollar of inflated earnings.[158] One hopes these results are not typical. Managers who are willing to commit fraud to inflate earnings probably are less concerned about shareholder value than honest managers. Nonetheless, the study emphasizes the obsession of some managers with reported earnings.

E. Survey Evidence Concerning the Effects of Accounting on Corporate Behavior

John Graham, Campbell Harvey, and Shiva Rajgopal have recently surveyed more than four hundred financial executives and conducted in-depth interviews with twenty more in an attempt to better understand the role and importance of corporate financial reporting.[159] They found that CFOs are extremely concerned, perhaps obsessed, with meeting stock analysts' consensus earnings forecasts.[160] Over half of the respondents indicated that they would be willing to sacrifice cash flow if necessary to achieve earnings targets.[161] Interestingly, the respondents appeared more willing to adjust operations to achieve earnings targets than to make permissible adjustments to their accounting practices.[162] Respondents thought that sacrificing cash flow for

---

157. Merle Erickson et al., *How Much Will Firms Pay for Earnings That Do Not Exist?: Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387 (2004).

158. *Id.* at 389.

159. *See generally* Graham et al., *supra* note 38.

160. *Id.* at 9–10. This finding is consistent with S.P. Kothari's 2001 assessment that "the evidence is fairly strong that managerial behavior is consistent with the market behaving as if it is functionally fixated on reported accounting numbers, but that the security price behavior itself is at worst only modestly consistent with functional fixation." Kothari, *supra* note 22, at 197.

161. Graham et al., *supra* note 38, at 15–16.

162. *Id.* at 16.

earnings was unfortunate, but appropriate, given the adverse effect of missed earnings targets on stock prices and market confidence.[163]

While the study confirms management fixation with earnings, it provides little evidence supportive of positive accounting theory. Less than 30% of respondents agreed or strongly agreed with the statement that "meeting earnings benchmarks helps us avoid violating debt-covenants."[164] Moreover, CFOs downplayed the impact of hitting earnings targets on their own short-term compensation (no surprise), but interviews revealed that longer term career concerns motivate managers to "make their numbers."[165] Although CFOs report that their interests and those of shareholders are aligned in this respect, a focus on career concerns could reflect agency problems. Particularly troubling was the fact that the CFOs assigned an average probability of just over 50% to the likelihood that their firms would pursue a positive net present value project that reduced quarterly earnings by $0.10 per share (about 7%) even if their firms would not achieve the consensus earnings target by forgoing the project.[166] One is forced to wonder whether managers are more concerned about the incremental damage to share price of missing an earnings target by a greater margin or the incremental embarrassment and personal taint.

IV. Does Accounting Matter? Synthesis of the Theory and Evidence

There can be little doubt that accounting matters. There is abundant evidence that managers are sensitive to reported earnings and sacrifice cash flow, as in *Kamin*, to boost earnings, and that changes in mandatory accounting standards affect corporate behavior. However, evidence of systematic variation in discretionary accounting choices and in corporate responses to mandatory accounting standard changes consistent with share value enhancing aspects of positive accounting theory is mixed. For example, a recent survey article concluded that the data suggest a relationship between debt and accounting but that the empirical results are inconclusive, and thus, "we cannot draw definitive inferences."[167] Given the weakness of the stock price reaction studies, it is plausible, perhaps likely, that accounting choice, lobbying against earnings-reducing standard changes, and reaction to mandatory standard changes reflects

163. *Id.* at 2.
164. *Id.* at tbl.4.
165. *Id.* at 13.
166. *Id.* at tbl.7.
167. Fields et al., *supra* note 22, at 275.

self-serving management behavior and agency costs as much as or more than the concern with share value maximization.

This Part will take one last look at *Kamin* and managerial resistance to stock option expensing in light of the theory and evidence discussed in the previous two Parts. The stock option expensing saga leads one to question whether and why the effect of accounting rules on corporate behavior is persistent. As suggested in the previous Part, one might find management resistance to absorbing a large one-time earnings hit unsurprising, but expect that, with respect to ongoing activities, firms and markets would adjust to changes in accounting rules over time, rendering most behavioral effects short-lived. But if so, why would managers fight so hard to avoid stock option expensing? The last section of this Part will consider the persistence question more generally before we take up the issue of book-tax conformity in the next Part.

A. Kamin v. American Express

The American Express directors' justification for distributing the depreciated DLJ shares, as reflected in the board minutes and reported by the judge in *Kamin*, was that a $26 million "reduction of net income would have a serious effect on the market value of the publicly traded American Express stock."[168] That seems highly unlikely. First, as discussed above, even if one is skeptical of the efficiency of U.S. stock markets, it is very hard to imagine that, in this case, the market had not already adjusted American Express's stock price to reflect the unrealized loss on such a large, discrete, publicized investment.[169] Direct price effects are improbable.

Second, it is difficult to believe that contracting costs related to debt covenants drove the decision to distribute the securities and forgo the tax benefit. Apparently, this was an isolated incident, reducing the benefit of renegotiation, but, on the other hand, renegotiation for a one-time event would have been relatively simple. For distribution of the depreciated shares to have been a rational decision in accordance with the debt covenant hypothesis, one would have to conclude that a one-time $26 million earnings hit increased the expected cost of technical debt default by $8 million and that renegotiating debt covenants to account for this charge to earnings would have cost $8 million or

168. Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811 (Sup. Ct. 1976).

169. Even Lynn Stout, who is skeptical of the informational efficiency of markets, admits that "[i]nformation that is easy to understand and that is trumpeted in the business media . . . may be incorporated into market prices almost instantaneously." Stout, *supra* note 23, at 656.

more. Moreover, the political cost story runs counter to the directors' decision. According to Watts and Zimmerman, companies prefer to report lower earnings to stave off tax increases or other political costs.[170]

That leaves us with employment contract effects. Reported earnings apparently factored into the compensation of some of the inside directors (and presumably other employees). If these agreements are sticky, reducing reported earnings could have costs (lower productivity) and benefits (lower compensation paid), but in all likelihood, the net compensation effect of reduced reported earnings would have been positive for shareholders. In any event, it seems highly unlikely that the share value impact resulting from the one-time charge against earnings could have approached $8 million.

It is much more likely that *Kamin* is a case of managerial preferences for earnings exceeding shareholder preferences and managers acting on their preferences—in other words, a classic agency problem. It would be nice to be able to say (as I have done in my corporate law class for several years) that the directors' decision in *Kamin* was unambiguously against shareholder interests, but we cannot honestly say that, given our current understanding of accounting theory. However, the burden should have been on the directors to explain how the indirect effects of a one-time earnings hit could offset the forgone tax benefits. Rather than relying on a general statement about the "serious" market effects of a reduction in net income, the onus should have been on the directors and their experts to explain why an accounting-driven reduction in earnings would have a serious effect. Was the company very highly leveraged? Would the earnings reduction have triggered technical default? Was renegotiation of debt covenants or other alternatives to forgoing the tax benefit considered? What were the costs of these alternatives? If management is unable to provide a cost/benefit analysis at least plausibly justifying a decision to sacrifice tax benefits for earnings, that decision should not be protected from judicial scrutiny under the prevailing corporate law standard.[171]

---

170. WATTS & ZIMMERMAN, *supra* note 13, at 223; Ross L. Watts & Jerold L. Zimmerman, *Towards a Positive Theory of the Determination of Accounting Standards*, 53 ACCT. REV. 112, 115 (1978).

171. Unfortunately, the legal burden on directors in cases like *Kamin* is minimal. In most U.S. jurisdictions, unless there is clear self-dealing, courts defer to the *rational* business judgment of the directors. ROBERT CHARLES CLARK, CORPORATE LAW 123–25 (1986). However, in order to earn the protection of the "business judgment rule," the directors must demonstrate, inter alia, that they were reasonably informed with respect to the matter. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (2005). The shareholders' argument in a future case like *Kamin* should be that directors who rely on unsupported assertions that purely accounting-driven earnings reductions impair share value have not earned the protection of the business judgment rule because they have not made themselves reasonably informed in light of the theory and evidence. However, given the resistance of courts to second guess managerial

B. *Managerial Opposition to Stock Option Expensing*

Similarly, managerial opposition to stock option expensing cannot be dismissed out of hand as antagonistic to shareholder interests given our current knowledge of accounting theory. We can be fairly certain that moving fully disclosed stock option expense from the footnotes to the income statement will not have a direct effect on stock prices, but the change surely will involve some contracting costs. If the debt covenant costs associated with this earnings-reducing change exceed the political and employment cost savings, some reduction in share prices should be expected. And, unlike the *Kamin* situation, there is no tax or other direct financial benefit associated with the accounting change to offset the increased contracting costs.[172] So, at one level, managerial opposition to the change seems rational.

However, there are reasons to suspect that managerial opposition to option expensing resulted from more than the indirect effect of the standard change on share value. First, although the standard change presumably would be permanent, debt and compensation agreements are not. Although deviating from GAAP has costs, new debt agreements and employment contracts could be based on earnings excluding option compensation expense if the parties believe that this measure better serves their purposes. The evidence from one study indicates that parties to debt contracts increasingly are deviating from rolling GAAP when specifying debt covenants.[173] Thus, the debt contracting costs associated with the change are limited to the impact on existing agreements and the cost of deviating from GAAP going forward, which presumably are modest.

Second, as in *Kamin*, political and employment effects associated with the change presumably would be positive and offset the other contracting costs to

---

decisions and additional statutory protections for managers, particularly in Delaware, the prospects for such an argument are not good. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697, 760 (Del. Ch. 2005) (finding that although "many aspects of defendants' conduct . . . fell significantly short of the best practices of ideal corporate governance," the Disney directors were at most "ordinarily negligent" and thus they were insulated from liability in accordance with the business judgment rule); *see also* DEL. CODE ANN. tit. 8, § 102(b)(7) (2006) (permitting Delaware companies to include in their charters exculpatory "provision[s] eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director," with exceptions for, inter alia, breaches of the duty of loyalty and "acts or omissions not in good faith").

172. This is not to say that there is no benefit to shareholders from rationalizing compensation accounting. Assuming that managers are utilizing options excessively because of their favorable accounting treatment, a level playing field should result in a more efficient mix of compensation.

173. Mohrman, *supra* note 52, at 82–83.

some extent. Third, we should not forget the evidence that managerial opposition to the 1993 option expensing proposal reflected concerns with increased management pay exposure rather than contracting costs. Once again, agency costs likely best explain managerial resistance to options expensing.

C. Are Earnings Effects Persistent?

Juxtaposition of *Kamin* and the evidence of managerial resistance to stock option expensing leads one to question whether the behavioral effects of accounting are persistent, and if so, why? With respect to ongoing activities, one would imagine that firms would eventually contract around inefficient GAAP rules, and we have seen evidence that parties to debt contracts increasingly do.[174] However, historical stock option practice suggests that accounting rules can have persistent effects. Now that the accounting preference for stock options has been eliminated, it appears that the use of options may be declining, but while the preference existed, reliance on option compensation increased steadily. Firms and markets did not contract around the accounting preference for options; they embraced it.[175] Moving beyond the realm of options, recall that corporations responded to the imposition of accrual accounting for post-retirement health care benefits by permanently reducing those benefits, not by adjusting their debt and compensation contracts,[176] and that some firms have consistently failed to disqualify incentive stock options in the face of tax benefits.[177] On the other hand, there is some evidence suggesting that tax benefits dominate earnings effects in firms' inventory accounting choices, which supports the idea that firms and markets adjust rationally to maximize after-tax cash flow over the long haul. However, as noted above, even here, we cannot be sure that some FIFO firms have not left tax benefits on the table as a result of earnings concerns.

Possibly, the examples suggesting persistence are anomalies, and companies typically do adjust. However, given this evidence, it is worth pondering why firms might alter behavior rather than adjust debt covenants and compensation contracts to neutralize the effect of unfavorable accounting rules.[178]

---

174. *Supra* note 52 and accompanying text.

175. *Supra* note 98 and accompanying text.

176. *Supra* notes 85–87 and accompanying text.

177. *Supra* notes 139–42 and accompanying text.

178. One possibility is that the stock market is not semi-strong efficient. Perhaps reported earnings affect share prices because of the cost and difficulty of incorporating this information.

As discussed above, the debt covenant hypothesis provides little help in explaining persistent behavioral effects of accounting rules because covenants could be based on a combination of GAAP and non-GAAP rules, or anticipating potential rule changes, the parties could elect to base covenants on the GAAP rules in force at the time the covenants are entered into.[179] Thus, while it is costly to specify and maintain non-GAAP books, this effect is unlikely to contribute significantly to the persistence of corporate behavioral response to changes in GAAP.

However, agency theory could help explain the persistence of accounting effects, as the following examples demonstrate. First, suppose a manager's contract includes an earnings-based bonus. Under the pre-2005 accounting rules for options, the manager could increase earnings, and unless her compensation scheme was adjusted, increase her bonus by paying her subordinates with options instead of cash.[180] If the company's compensation committee negotiated executive pay at arm's length and had all of the information that the manager had, it would not allow her to profit from this artificial earnings increase. But monitoring executive compensation is costly and imperfect.[181] Moreover, the managerial power view of executive compensation suggests that managers have significant control over the compensation setting process, that executive pay negotiation often is not at arm's length, and that the ultimate cap on compensation may be unfavorable exposure and outrage.[182] Thus, while it may be more efficient for the company to pay its rank-and-file employees with cash and pay the manager a larger bonus, the artificially higher reported earnings and management bonuses associated with broad-based option compensation have the advantage of

---

For example, footnoted information may be deemed to be less reliable and authoritative than information provided in the body of audited financial statements. *Supra* note 30 and accompanying text. As argued above, this explanation seems unpersuasive as long as a choice between competing accounting rules has no *material* affect on publicly available information, but unexplained anomalies that challenge even the semi-strong version of the ECMH do exist. *Supra* Part II.A.

179. Mohrman, *supra* note 52, at 78–79.

180. Cash compensation results in a dollar for dollar reduction in earnings. Under the pre-2005 accounting rules, properly designed options resulted in no reduction in earnings at grant, exercise, or any other time. *Supra* note 97 and accompanying text.

181. *See generally* Jensen & Meckling, *supra* note 63, at 305–60 (describing the managerial agency problem). For additional discussion of the challenges of controlling managerial compensation under various theories of corporate governance, see David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587 (2005).

182. Bebchuk et al., *supra* note 61, at 783–95. *See also* BEBCHUK & FRIED, *supra* note 61, at 61–79 (providing an overview of various features of the managerial power model).

subtlety. It would not be surprising for the manager and, indeed, the directors to prefer this option.[183]

Second, suppose an executive believes that her reputation as a manager and future career prospects depend on her ability to consistently meet or exceed consensus earnings forecasts. Faced with an earnings-decreasing change in accounting rules that may not have been fully appreciated by analysts, such as the promulgation of SFAS 106, the manager may be tempted to make irrevocable operational choices, e.g., slashing post-retirement health care benefits, that restore earnings rather than attempting to explain away the adverse results to analysts.[184] Similarly, an executive may decide against adopting a proposed operational change that carries adverse accounting consequences, such as shifting away from option compensation under the pre-2005 rules, given concerns over the move's impact on the firm's ability to achieve earnings targets in the current period or some future period. These effects could well be persistent, particularly if a firm's competitors can be expected to make earnings-enhancing choices.

It could well be the case that potential earnings effects exert greater influence over discrete decisions, such as the choice between selling and spinning off a significant asset, than over ongoing activities, such as the choice of inventory accounting methodology. However, as we have seen, even with respect to ongoing activities, there is both evidence and theory supporting the idea that the behavioral effects of accounting are persistent.

V. Book-Tax Conformity

U.S. public companies maintain separate tax and financial accounts, prepared under different rules and producing different results. The administrative cost of maintaining multiple sets of books has long been recognized, but justified as necessary, given the differing purposes of and audiences for tax and financial reports.[185] In recent years, however, the focus has been on the growing gap between

---

183. *See* Bebchuk et al., *supra* note 61, at 786–89 (arguing that directors are sensitive to investor outrage over executive compensation and prefer pay packages that deflect outrage).

184. Almost 60% of CFOs surveyed by Graham, Harvey, and Rajgopal agreed or strongly agreed that one reason their firms emphasized achieving earnings targets was that missing the targets required management to spend a lot of time explaining the miss to analysts rather than discussing future prospects. Graham et al., *supra* note 38, at tbl.5.

185. *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1979) (discussing differing goals of and audiences for financial and tax accounting); *see also* Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal* 5 (N.Y. Univ. Law & Econ. Research Paper Series, Working Paper No. 07-38, 2007), *available at* http://ssrn.com/abstract=1017073 (arguing that absent managerial and political agency problems, optimal tax and accounting income "measures would diverge significantly"

earnings reported to investors (relatively high) and income reported to the taxing authorities (relatively low) and suspicion that part of this gap represents inappropriate tax avoidance and/or earnings inflation.[186] Of course, part of the gap flows from explicit tax incentives, such as accelerated tax depreciation, or from recognized financial accounting anomalies, such as the failure until recently to record compensatory stock options as an expense. It is widely believed, however, that these deviations represent only part of the gap.[187] Reformers argue that tax shelters and earnings inflation schemes tend to rely on discontinuities between book and tax accounting. Companies seek out techniques that will allow them to report less taxable income without reducing reported earnings, and they prefer earnings enhancement schemes that do not result in increased taxable income.[188] Eliminating discontinuities, some argue, would tend to discourage these activities.[189] In a world of full conformity between financial and tax accounting rules, companies could not inflate earnings without paying additional taxes and could not cut taxes without cutting earnings as well.

Of course, no one suggests that even full book-tax conformity would be a panacea. Even faced with a tradeoff, firms may inappropriately shelter income from tax or inflate earnings. In *Kamin*, the book and tax treatment of the disposition of the shares were in conformity. American Express faced a tradeoff between minimizing taxes and maximizing reported earnings, and chose the latter. Of course, *Kamin* did not involve accounting fraud or tax sheltering, but the suggestion is that without the counterweight provided by conforming book and tax accounting treatments, companies are more likely to stretch the rules in seeking to maximize earnings and minimize tax.

---

but advocating book-tax conformity as a means of combating those agency problems).

186. *See* Lillian F. Mills & George A. Plesko, *Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income*, 56 NAT. TAX J. 865, 867–68 (2003) (providing data on the increasing ratio of book income to taxable income between the early 1970s and late 1990s and citing other evidence of an increasing gap in the 1990s); Hanlon & Shevlin, *supra* note 12, at 2 (noting the increasing divergence between book and tax income and expressing concern that the difference may be a result of misleading or fraudulent reporting); George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1798 (2003) (confirming conclusions of previous studies finding an increased gap between book and taxable income in the late 1990s).

187. *See, e.g.*, Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, *in* 17 TAX POLICY AND THE ECONOMY 169, 169–201 (James M. Poterba ed., 2003) (arguing that differences arising from the disparate treatment of depreciation, stock options, and foreign source income do not explain the entire book-tax difference and suggesting tax sheltering as the likely explanation for the residual difference).

188. Yin, *supra* note 11, at 225.

189. *Id.*

The pros and cons of increased book-tax conformity have been widely debated.[190] However, the behavioral impact of accounting standards has not been fully considered by the participants in this debate.[191] This Part argues that the behavioral effects would be largely negative. Many of the existing gaps between tax and financial accounting rules, such as depreciation rules that allow companies to report higher earnings to investors than the IRS, can be thought of as tax incentives, accounting incentives, or both. However increased book-tax conformity is achieved, the result will be erosion of these incentives. The potential adverse economic effects represent an unappreciated cost of book-tax conformity and provide reason to prefer the alternative of increased disclosure and reconciliation between financial and tax accounts.

A. Book-Tax Conformity Proposals

Book-tax conformity could be advanced in many ways. Full conformity could be achieved by assessing corporate taxes on income reported under GAAP or by requiring that financial accounts be prepared consistent with the Internal Revenue Code. Both financial and tax accounting could be based on a compromise set of rules between the current tax code and GAAP. Other options include using one of the foregoing as a baseline for both tax and financial reporting but providing for

---

190. Scholarly articles proposing or supporting some form of increased book-tax conformity include Desai, *supra* note 11; Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax "GAAP,"* 2001 COLUM. BUS. L. REV. 539 (2001); Celia Whitaker, *Bridging the Book-Tax Accounting Gap*, 115 YALE L.J. 680 (2005); Yin, *supra* note 11; and Shaviro, *supra* note 185. Calls for increased conformity in the popular press are common as well. *See, e.g.*, Alan Murray, *Narrowing Tax Gap Should Be Priority of Next Congress*, WALL ST. J., Oct. 8, 2002, at A4 (arguing that Congress should act to increase reporting conformity). Articles criticizing or questioning increased conformity include Johnson, *supra* note 12; Terry Shevlin, *Corporate Tax Shelters and Book-Tax Differences*, 55 TAX L. REV. 427 (2002); Michelle Hanlon et al., Evidence on the Possible Information Loss of Conforming Book Income and Taxable Income (Jan. 12, 2007) (unpublished working paper, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=686402; Hanlon & Shevlin, *supra* note 12. Other useful articles examining book-tax conformity include Desai, *supra* note 187, and Wolfgang Schon, Lecture, *The Odd Couple: A Common Future for Financial and Tax Accounting*, 58 TAX L. REV. 111, 115–16 (2005).

191. In a recent paper, Doug Shackelford, Joel Slemrod, and James Sallee model the effect of tax and accounting on the real decisions of firms and suggest that book-tax conformity would affect these decisions as well as the level of income reported for tax and financial accounting purposes. Douglas A. Shackelford et al., A Unifying Model of How the Tax System and Generally Accepted Accounting Principles Affect Corporate Behavior 38 (Jan. 12, 2007) (unpublished working paper, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=223729. One of their insights is that activities that create flexibility for financial reporting will be favored. *Id.* at 39.

specific deviations for one of the two sets of books. The most common proposals advocate a partial conformity approach utilizing GAAP as a baseline but anticipating that Congress would specify certain discrete deviations for tax accounting.[192]

Partial conformity is not wholly alien to U.S. accountants. As we have seen, firms that elect to use LIFO inventory accounting for tax purposes are required to report earnings on the same basis. But inventory accounting is an isolated example of book-tax conformity in the United States. Book-tax conformity is much more common in countries that traditionally have relied less on public markets to provide corporate finance, such as Germany, France, and Japan.[193] In those countries mandated conformity often allows for company choice along the lines of the U.S. LIFO/FIFO example. German companies, for example, may elect to accelerate depreciation for tax purposes only if the depreciation deductions are reflected equally in the financial accounts.[194]

Of course, in one sense, the current U.S. system could be thought of as a "partial" book-tax conformity system. The tax code does provide that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[195] But the exceptions swallow the rule, and the courts have long acknowledged that taxpayers cannot rely on GAAP where contrary to tax rules and regulations.[196]

B. Issues and Concerns with Book-Tax Conformity Proposals

My principal aim in this Part is to call attention to several unrecognized or underappreciated problems with book-tax conformity that arise from the effects of financial accounting on managerial and corporate behavior. However, before addressing those issues in the next section, this section summarizes and expands upon a number of other concerns with increased conformity.

---

192. *See* Desai, *supra* note 11, at 21 (suggesting this type of partial conformity); Engler, *supra* note 190, at 559–61 (same); Whitaker, *supra* note 190, at 721–22 (same); Yin, *supra* note 11, at 224–25 (same); *see also* Shaviro, *supra* note 185, at 50–58 (proposing an adjustment to the taxable income of large, public companies equal to a percentage of the difference between unadjusted taxable income and reported earnings, but allowing for the possibility that Congress would exempt certain tax preferences from the adjustment).

193. Paul J. Rutteman, *A Comparative View of Accounting Regulations*, *in* THE SEC AND ACCOUNTING: THE FIRST 50 YEARS: 1984 PROCEEDINGS OF THE ARTHUR YOUNG PROFESSORS' ROUNDTABLE 95, 99–105 (Robert H. Mundheim & Noyes E. Leech eds., 1984).

194. *Id.* at 100; Schon, *supra* note 190, at 115–16.

195. I.R.C. § 446(a) (Supp. IV 2005).

196. *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 538–44 (1979) (finding no presumption that practices consistent with GAAP are valid for tax purposes).

1. Information Loss

The primary aim of financial accounting is to provide relevant, reliable, consistent, and comparable financial information to the capital markets in order to ensure efficient allocation of resources,[197] and a principal concern of accounting researchers is that book-tax conformity would lead to a loss of value-relevant information.[198] Generally, financial accounting standards best fulfill their information-providing role when they produce results that mirror economic accounting results, e.g., when financial depreciation mirrors economic depreciation. Thus, some scholars argue that requiring financial statements to be prepared on the basis of tax accounting rules, or even conforming somewhere in between current financial and tax accounting rules, would result in the loss of value-relevant information.[199] Studies demonstrate that financial statements are indeed less relevant in countries in which tax rules influence financial accounting rules.[200]

However, research shows that tax and financial accounts contribute individually to the efficiency of the market.[201] As a result, even if GAAP were accepted as the basis for both books, there would be a loss of information.[202] To be sure, the loss would be greater if financial accounts were prepared on the basis of the tax rules, but the elimination of either set of books would be costly from an information perspective.[203]

---

197. *See* FIN. ACCOUNTING STANDARDS BD., FACTS ABOUT FASB 1 (2007), http://72.3.243.42/facts/facts_about_fasb.pdf (providing FASB mission statement) (on file with the Washington and Lee Law Review).

198. Hanlon et al., *supra* note 190, at 2; Hanlon & Shevlin, *supra* note 12, at 5.

199. *See* Hanlon & Shevlin, *supra* note 12, at 5 (referencing recent research as supporting the predicted loss of information). While book-tax conformity could theoretically occur anywhere along the continuum between financial accounting standards and tax accounting rules, Hanlon and Shevlin assume that Congress would not be willing to cede control of tax rules to a private standard setting body and that conformity would likely occur at or near tax accounting. *See id.* at 18 (discussing the practicalities of conformity). *But see* Whitaker, *supra* note 190, at 709 (arguing for book-tax conformity with a financial accounting baseline and limited specific deviations for tax purposes); Yin, *supra* note 11, at 224 (same).

200. *See* Hanlon & Shevlin, *supra* note 12, at 23 (citing Ashiq Ali & Lee-Seok Hwang, *Country Specific Factors Related to Financial Reporting and the Value Relevance of Accounting Data*, 38 J. ACCT. RES. 1 (2000)).

201. Hanlon et al., *supra* note 190, at 37.

202. *Id.*

203. *See id.* (estimating that if the accounts were conformed based on tax rules, the reduction in the explanatory power of the income measure would be on the order of 50% but arguing that even conformity at GAAP would result in the loss of incremental information provided by the taxable income measure).

2. *Control of Tax Policy*

Some commentators doubt that Congress would be willing to cede control over tax rules to the FASB.[204] Full conformity based on GAAP would result in a change in tax law every time the FASB issued a new standard. Even partial conformity with a GAAP baseline would cede substantial control of tax policy to the FASB. Unless Congress had already enacted a specific exception for a particular item or transaction, a change in GAAP would result in a change in tax unless and until Congress acted to override the change for tax purposes. Other arrangements for sharing responsibility are feasible, but a GAAP baseline for tax assessment seriously conflicts with congressional control over tax policy.[205]

Of course, some commentators, following the lead of Stanley Surrey, would applaud a change that would make it more difficult for Congress to implement social or economic policy via the tax code.[206] But the idea of Congress abandoning tax incentives is probably unrealistic. One could argue that if Congress's principal concern was the revenue associated with the corporate tax, Congress could easily cede responsibility for tax accounting to the FASB and simply adjust the tax rates as necessary. However, if Congress is as or more concerned with economic intervention via the tax code, then the likelihood is that a GAAP baseline tax with specific exceptions would rapidly degenerate into something approaching the current tax code as Congress enacted various tax favors, incentives and penalties. It seems much more likely that tax rules would serve as the basis for any book-tax conformity proposal acceptable to Congress.

3. *Instability Generally*

Essentially for the reasons given above, Hanlon and Shevlin have argued that partial conformity is inherently unstable, particularly partial conformity based on a GAAP baseline.[207] Once exceptions to a GAAP-based tax are allowed, they argue, special interest lobbying would lead to greater and greater discontinuities. Full conformity may be unrealistic, but if achieved, it could

---

204. Hanlon & Shevlin, *supra* note 12, at 5; Shevlin, *supra* note 190, at 435.

205. *See* Shevlin, *supra* note 190, at 434 (discussing options for shared responsibility between Congress and the FASB).

206. *See infra* Part VI.C.6 (discussing inefficiencies highlighted by Surrey in the provision of economic incentives through the tax code).

207. Hanlon & Shevlin, *supra* note 12, at 28–30.

possibly be maintained. It is difficult to imagine a GAAP-based tax with a handful of specific tax exceptions not becoming two essentially separate systems.

4. *Politicization of the Financial Accounting Standard-Setting Process*

Compared with the tax writing process, financial accounting standard setting seems blissfully nonpolitical. Of course, business people lobby the FASB,[208] and Congress and the SEC exert their influence from time to time,[209] but by maintaining its emphasis on neutral rules of accounting, the FASB has deflected a great deal of potential interference. Increased book-tax conformity would almost inevitably lead to the politicization of financial accounting.[210]

Consider the scenario in which current tax rules or some hybrid between current tax and accounting rules enacted by Congress form the basis for both sets of books. Financial accounting would become just as much a political football as taxes are today, and lobbying would increase for the following reasons: First, public companies would have more at stake in the rules selected by Congress because these rules would control for both tax and accounting purposes. Second, Congress's freedom to insert special interest accounting favors (or penalties) would increase given the shift from a single goal of promulgating neutral accounting standards to a multi-purpose, multi-policy tax and accounting standard-setting process. Increasing the stakes in a venue that is more susceptible to lobbying would increase the expected payoffs from lobbying, and thus should result in more lobbying.[211]

---

208. *See, e.g.*, Lawrence D. Brown & Ehsan H. Feroz, *Does the FASB Listen to Corporations?*, 19 J. BUS. FIN. & ACCT. 715, 727–29 (1992) (finding that the FASB is influenced by corporate comment letters and that larger corporations have more influence than smaller ones).

209. *Infra* Part VI.C.3.

210. *See* Shevlin, *supra* note 190, at 434–35 (noting the inevitability of congressional involvement in standard setting with increased book-tax conformity); *but see* Shaviro, *supra* note 185, at 42–50 (providing a thorough discussion of the potential politicization problem, but proposing an earnings adjustment to taxable income as a means of increasing book-tax conformity while minimizing the risk of congressional intervention in the accounting standard setting process).

211. According to the economic theory of regulation, the benefits and burdens that are granted or imposed by the state on firms are subject to the laws of supply and demand, and lobbying expenditures are determined like any other business expenditure. Managers compare the expected payoffs from lobbying against other profit-seeking opportunities in optimizing the allocation of corporate resources. Under this model, the stakes and susceptibility of the regulator to being influenced are important determinants of lobbying effort and expenditure. *See* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (the seminal article on the economic theory of regulation); *see also* FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION 1–19 (1997) (providing an overview of the economic theory of regulation

On the other hand, suppose that a GAAP-based tax approach were adopted with specific tax deviations enacted by Congress. The FASB's influence over taxes would be significant in any mixed responsibility scenario. Despite the FASB's neutrality stance, businesses could be expected to increase their lobbying of that organization, given the increased stakes involved in the FASB's pronouncements. Moreover, because the odds of a congressional tax override would be uncertain, pressure on individual members of Congress to intervene in the FASB's deliberations could be intense. It may not be realistic to expect a private group of accountants to be able to navigate these political waters and successfully set both accounting rules and default tax rules. Even if it is feasible, this would not be an appropriate role for a private organization like the FASB. This realization provides some reason to think that conformity, if it is to occur, may be more likely to happen at the tax end of the spectrum and fall firmly within congressional control. The primary point, however, is that any book-tax conformity proposal entails the politicization of financial accounting standard setting.

C. Book-Tax Conformity and Corporate Behavior

The costs of book-tax conformity described above are serious, but of course the benefits could be greater. This section, however, presents several additional concerns arising out of the influence of accounting results on managerial and corporate behavior that further undermine the case for book-tax conformity. In brief, the concerns are that increased book-tax conformity (1) is less likely to forestall artificial earnings inflation than most commentators assume, and indeed may result in excessive sacrifice of tax benefits for earnings; (2) will result in reduced consistency in financial reporting than exists today, making cross-company comparisons more difficult; and (3) will undermine economic incentives whether conformity occurs at the tax end of the spectrum, the book end, or somewhere in between.

1. Accounting and Operational Flexibility and the Book-Tax Tradeoff

Because of the forced tradeoff between high reported earnings and happy investors on the one hand, and low taxable earnings and low corporate taxes on the other, book-tax conformity has been suggested as a response both to tax sheltering and artificial earnings inflation, depending on the dominant concern

---

and focusing on the burden side of the equation, i.e., on the power of government to extort wealth from industry under the threat of adverse regulation).

at the time. Fair enough, but is book-tax conformity more likely to reduce sheltering or inflated earnings? Where would firms come out on the continuum between tax minimization and earnings maximization? As long as there is some managerial discretion over accounting choice and operational decisions, it would be impossible for a regulator to tie corporations to a point along that continuum.

Most commentators who have addressed this issue have suggested that tax minimization would dominate.[212] The analysis developed herein suggests otherwise. It seems likely that book-tax conformity would result in managers sacrificing tax benefits for earnings to a greater extent than shareholders would prefer, at least in the near term. Thus, increased book-tax conformity may be a partial answer to tax sheltering, but it may also result in some reduction in share values as managers act to maximize their own utility rather than that of shareholders.

a. Flexibility in Managing Taxes and Earnings

Whether conformity is achieved based on GAAP, the tax code, or something in between, managers would retain flexibility to manage taxes and earnings. Current GAAP is much more flexible than the tax code, and a certain degree of financial accounting flexibility is generally viewed as a positive feature. There are many users of financial data, and the flexibility in GAAP allows firms to choose the accounting treatments that most efficiently portray data and minimize contracting costs.[213] But given the flexibility of GAAP, assessing corporate tax on reported income would provide companies with broad discretion to minimize tax or maximize reported earnings with respect to such key inputs as recognition of revenues and costs, inventory valuation, and depreciation.[214]

A book-tax conformity approach utilizing a GAAP baseline with specific tax departures could provide either more or less flexibility than a straight GAAP-based tax, depending on whether the departures were mandated or made optional. In all likelihood, the result would be some of both. One can imagine Congress providing optional tax incentives for items such as depreciation and

212. *Infra* notes 219–23 and accompanying text.

213. *Supra* note 45 and sources cited therein.

214. *See* JAMIE PRATT, FINANCIAL ACCOUNTING IN AN ECONOMIC CONTEXT 84–89, 279–86, 368–73 (6th ed. 2006) (explaining accounting rules and choices relating to revenue and expense recognition, inventory valuation, and depreciation).

mandatory tax penalties for items such as nonperformance based executive compensation.[215]

The current tax code provides less flexibility than GAAP, but some discretion does exist. For example, accelerated tax depreciation is not mandatory; firms can elect to apply straight-line tax depreciation.[216] Firms may elect to deduct certain research and experimental expenditures instead of capitalizing them, but they are not required to do so.[217]

Of course, even if accounting rules were nondiscretionary, accounting discretion would remain to the extent of operational discretion. For example, many companies have significant flexibility in managing accruals at year end.[218] Under any of these approaches, operational flexibility would leave firms with choices between minimizing taxes and maximizing reported earnings.

b. The Book-Tax Tradeoff

How would firms exercise accounting and operational discretion in a book-tax conformity regime? Firm believers in the efficient capital markets hypothesis suggest that the primary result would be reduced reported income. Calvin Johnson has argued that companies would find other ways to communicate information to investors and would manage their books solely with an eye to minimizing taxes.[219] Michelle Hanlon and Terry Shevlin have suggested that book-tax conformity could lead to a "race to the bottom" on effective tax rates.[220] Peter Joos and Mark Lang have argued that book-tax conformity in Germany and France "has provided incentives to reduce taxes by reporting lower profits."[221]

---

215. These approaches would be consistent with the current tax code. As discussed below, accelerated tax depreciation is optional under I.R.C. § 168(b) (Supp. IV 2005). *Infra* note 216 and accompanying text. On the other hand, the tax code contains mandatory tax penalties related to excessive provision of nonperformance based executive compensation. I.R.C. § 162(m).

216. I.R.C. § 168(b)(3)(D).

217. *Id.* § 174(a).

218. *See, e.g.*, Paul K. Chaney & Craig M. Lewis, *Earnings Management and Firm Valuation Under Asymmetric Information*, 1 J. CORP. FIN. 319, 319–20 (1995) (citing studies and relating anecdotal evidence of accrual management).

219. Johnson, *supra* note 12, at 427.

220. Hanlon & Shevlin, *supra* note 12, at 28.

221. Peter Joos & Mark Lang, *The Effects of Accounting Diversity: Evidence from the European Union*, 32 J. ACCT. RES. 141, 145 (1994).

Other commentators are less convinced, pointing out the moderating effect of management's motivation to report high earnings.[222] The lessons of this Article lend support to the latter view: Increased book-tax conformity would likely lead to increased instances of managers sacrificing legitimate tax benefits in order to maintain or boost reported earnings.

The empirical literature on accounting choice provides evidence that increased book-tax conformity that leaves discretion with managers to choose between high earnings/high tax and low earnings/low tax treatments would not necessarily result in tax minimization. Faced with tradeoffs between asset sales and spin-offs and the possibility of disqualifying incentive stock options, managers routinely forgo tax benefits in order to preserve earnings.[223] Moreover, although the inventory accounting literature suggests that managers of some large firms get the tradeoff "right," i.e., choose LIFO and cash flow over earnings, we cannot be sure that of the large majority of firms that utilize FIFO, a significant number aren't getting this wrong.[224]

Of course, positive accounting theory indicates that, to some extent, sacrificing taxes could be in the shareholders' interest. A tax minimization position would result in lower reported earnings that would increase the expected cost of debt covenant violation and/or require firms to contract around GAAP.

Consider depreciation. Although businesses are permitted to employ one of a number of approved financial depreciation methods for various depreciable assets, the most common technique is straight-line depreciation, which simply prorates the cost of an asset, less estimated salvage value, over the estimated useful life of the asset.[225] Straight-line financial depreciation is widely admired for its simplicity, but it is unlikely that this trait explains its dominance. After all, the same firms that utilize straight-line depreciation for financial reporting purposes utilize accelerated depreciation for tax purposes. Rather, straight-line depreciation is used for book purposes because, compared to the other permitted methods, it results in reduced depreciation expense and greater reported income in early years and increased expense and reduced reported

---

222. Schon, *supra* note 190, at 143.

223. *Supra* notes 130–35, 140–43 and accompanying text.

224. *Supra* notes 144–49 and accompanying text.

225. DAVID R. HERWITZ, MATERIALS ON ACCOUNTING FOR LAWYERS 471 (1980). *See also* K. FRED SKOUSEN ET AL., FINANCIAL ACCOUNTING 354 (6th ed. 1996). Skousen, Albrecht, and Stice relate a survey of 600 companies' annual reports finding that 558 employed straight-line depreciation, 50 employed the units-of-production method, and 106 employed accelerated methods. Obviously, a single company can employ different depreciation methods for different assets.

income in later years.[226] In other words, utilizing straight-line financial depreciation allows firms to maximize the present value of earnings reported to investors, while adopting accelerated depreciation methods for tax purposes allows firms to minimize the present value of taxes.

A firm that previously employed straight-line financial depreciation and switched to accelerated depreciation for both tax and book under a regime requiring consistency between book and tax but allowing for choice would suffer a reduction in reported earnings.[227] The debt covenant theory predicts that for some firms such a change would result in an indirect decrease in share price. The markets would see through the accounting change in pricing the company's securities, but absent renegotiation, the reduction in reported earnings would increase the likelihood of the firm violating covenants on existing debt. Covenants on new debt could be based on straight-line depreciation, despite the firm's election to use accelerated depreciation in reporting earnings, but doing so would entail keeping an additional set of non-GAAP books. Reduced political costs might offset the debt covenant effect, as the reduction in reported earnings deflected the attention of congressional tax writers. In addition, sticky employment contracts that are based in part on reported earnings would tend to result in reduced compensation payments that might or might not be accompanied by reduced productivity. It is unlikely that these effects would be large or persistent, but to some extent, the potential costs of financial distress initially and additional bookkeeping costs going forward would offset the tax savings associated with reporting the lowest possible levels of tax and financial income.

More importantly, however, given the direct and indirect effect of reported earnings on their own compensation and other factors, managerial decisionmakers are likely to sacrifice taxes for earnings to a greater extent than necessary to maximize share value. Book-tax conformity may reduce tax sheltering, but there is nothing to force managers to balance taxes against earnings in the shareholders' interests.

---

226. *See* SKOUSEN ET AL., *supra* note 225, at 354 (suggesting that the popularity of straight-line depreciation results from its simplicity and its effect on the timing of reported income).

227. Surprisingly, perhaps, a switch in the other direction to straight-line depreciation for tax as well as book purposes would have no impact on income reported *after-tax*, although it would clearly affect the timing of taxes. With respect to depreciation, tax and financial books are truly independent. The tax expense subtracted in calculating book earnings is adjusted to neutralize the effect of any timing differences between the depreciation methods used for book and tax. Lillian F. Mills, *Five Things Economists and Lawyers Can Learn from Accountants: An Illustration Using the Domestic Production Activities Deduction*, 59 NAT. TAX J. 585, 586 (2006).

To continue with the depreciation example, the reduction in reported earnings resulting from a switch from straight-line to accelerated financial depreciation would, absent renegotiation, result in reduced earnings-based bonuses for management. To be sure, managers faced with the imposition of increased book-tax conformity should be able to renegotiate their bonus formulas to adjust for the new regime. However, managers might choose to preserve their bonuses unilaterally (e.g., by electing to utilize straight-line depreciation for tax and book), rather than attempting to negotiate a new bonus formula, which might be perceived as a "raise," even if the adjustment would be fully justified by the change in accounting convention.[228]

Managers focused primarily on achieving quarterly earnings targets—out of career concerns, honest concerns about share value, or both—also might find themselves sacrificing taxes in choosing conforming accounting treatments for book and tax. Of course, to the extent that analyst earnings forecasts accurately reflect a company's choice of accounting rules, managers should be indifferent. Inevitably, however, analysts will fail to take into account every choice, and survey evidence indicates that CFOs are skeptical as to the ability of analysts to see through these choices.[229]

It is possible that operational decisions and accounting decisions would reflect different book-tax tradeoffs in a world of increased conformity. The empirical literature could be read as suggesting that earnings effects exert greater influence over discrete, operational decisions, such as that in *Kamin*,

---

228. The revised bonus might be perceived as a raise for several reasons. Imagine that Congress were to impose corporate taxes on the basis of reported GAAP income. In order to minimize taxes, firms might select income-reducing options among permissible GAAP rules, e.g., accelerated depreciation instead of straight-line depreciation. Obviously, these choices would reduce reported earnings. In order to maintain the dollar value of executive bonuses, the percentage of earnings dedicated to bonuses would have to increase. That change in formulas could be perceived as a raise. In addition, when the bonus is paid, it will, of course, represent a larger fraction of earnings. Again, this change could be perceived as a raise, despite the fact that it merely adjusts for the changes in accounting rules.

The managerial power theory of executive compensation suggests that managers will be loath to call unnecessary attention to their compensation. *See generally* Bebchuk et al., *supra* note 61, at 783–91 (discussing the managerial power approach). If managers can preserve pay through "self-help" accounting choices, why should they risk triggering outrage by renegotiating compensation contracts?

229. *See* Graham et al., *supra* note 38, at 26 (noting CFO concerns regarding inexperienced stock analysts). One might expect that while analysts might not account for the effect on earnings of minor accounting choices with small impacts, they would properly account for the effect of major accounting choices, such as depreciation techniques. However, even with respect to depreciation, there are numerous small subsidiary questions that affect the timing of expenses. In other words, the choice between straight-line and accelerated depreciation is just the beginning.

than over choices of accounting procedures with multi-year effects, such as inventory accounting.[230] Moreover, CFOs surveyed by Graham, Harvey, and Rajgopal indicate greater willingness to adjust operations than accounting practices in achieving earnings targets.[231] It is also possible that some firms might initially sacrifice tax benefits to maintain earnings but adjust over time to the new environment. In any event, the tax/earnings balance struck by U.S. corporate management, in aggregate, is likely to result in share value reductions and represents an underappreciated effect of increased book-tax conformity.

2. *Discretion and Cross-Company Consistency in Financial Reporting*

While enhanced book-tax conformity would increase consistency between the books of a given firm, conformity could result in a decrease in the consistency and comparability of accounting results between companies in the same industry, assuming some flexibility in accounting treatment in a book-tax conformity regime. Assuming that the markets see through accounting presentation, decreased inter-company consistency is not necessarily fatal to book-tax conformity proposals, but it does represent an added cost. To some extent, analysts would have to work harder to produce comparable figures.[232]

Imagine that corporate taxes were to be assessed on the basis of GAAP income. Firms would face a tradeoff between tax minimization and earnings maximization. In the case of depreciation, managers focused on tax minimization would adopt highly accelerated depreciation methods; those focused on earnings would select straight-line depreciation; some might compromise by selecting a modestly accelerated depreciation method. What factors would drive the choice? The debt covenant and political cost hypotheses suggest that degree of leverage and firm size would be determinants. In a previous section,[233] I argued that management earnings preferences would be a key factor, and the strength of those preferences and the extent to which they would be satisfied would depend on executive

---

230. *Supra* Part III.D.

231. Graham et al., *supra* note 38, at 18.

232. Although this section focuses on cross-company consistency of financial reporting, cross-company consistency of tax reporting is also an important issue. Achieving conformity by assessing taxes on the basis of GAAP would result in increased company discretion and variability in taxable income and taxes, which could have an adverse effect on the perceived fairness of the tax system and taxpayer compliance in general. Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 370–80 (2004).

233. Part V.C.1.

compensation design and other factors, including the quality of corporate governance. Given this multiplicity of factors, which may or may not be correlated among firms in a particular industry, accounting choices could vary widely, even among firms in a single industry. Surely, they would vary more widely than they do today.

I do not wish to overemphasize this point, and I do not suggest that the cost resulting from greater inter-firm variation in accounting choices would be significant. A nuanced view of the ECMH recognizes that information gathering and assimilation is costly. Decreased inter-firm consistency in accounting choice would directionally increase analytical costs, but in all likelihood the impact on market efficiency would be minimal.

3. Book-Tax Conformity and Economic Incentives

We have already considered the effect of book-tax conformity on firm choices among acceptable accounting treatments and operational decisions with accounting implications, such as year-end accruals. This section considers a related but much more pervasive and important issue: How would book-tax conformity affect the explicit economic incentives Congress provides in the tax code and the implicit economic incentives embedded in GAAP? I argue that increased book-tax conformity would undermine economic incentives whether conformity is based on GAAP, on the tax code, or on something in between.

a. Tax Incentives

As every student of basic federal income tax knows, the tax code is riddled with provisions that have little or nothing to do with "defining" income, i.e., determining the right level of income subject to tax in a platonic sense, and everything to do with providing incentives or subsidies to taxpayers. A familiar example is Section 106 of the Internal Revenue Code which generally excludes from the gross income of employees the value of employer provided health care and health insurance. Other in-kind benefits are included in an employee's income, so this exclusion represents a clear subsidy for the creation of employer funded health care plans.

Many of these tax incentives are directed at corporate behavior and at spurring business investment, including accelerated tax depreciation,[234] "bonus"

234. Taxpayers are allowed to take deductions for depreciation earlier and in greater amounts than "economic" depreciation would provide. Under I.R.C. § 168, the salvage values of assets are ignored, increasing the depreciable amount; the periods over which deductions are

depreciation,[235] investment tax credits,[236] and special "expensing" provisions permitting immediate deduction of expenditures that otherwise must be capitalized and recovered through depreciation.[237] The effect of each of these tax incentives is to increase the present value of deductions (and/or tax credits) associated with the expenditure and thus reduce the present value of taxes. By reducing the tax burden associated with qualified capital expenditures, Congress expects businesses will devote more of their resources to or accelerate capital investment.

Full book-tax conformity utilizing GAAP as a baseline would eliminate many of these tax incentives.[238] Unless the tax incentives were replaced with direct subsidies or other nontax incentives, we should expect some shift away from capital investment. Moreover, while some of the investment incentives are generic (accelerated depreciation applies to almost all depreciable assets and has been relatively stable over time), others are narrowly targeted. For example, investment tax credits currently are available for alternative energy development[239] and historic structure rehabilitation.[240] Taxpayers may elect to deduct or capitalize periodical circulation expenses,[241] certain research and experimental expenditures,[242] soil and water conservation costs,[243] environmental remediation costs,[244] and certain other expenditures.[245] In a bid to spur economic recovery in the wake of the 9/11 terrorist attacks, Congress implemented a limited term "bonus" depreciation provision allowing businesses to deduct immediately 30% (later increased to 50%) of otherwise depreciable

---

taken are shortened, often by as much as one-half of the assets' useful lives; and the depreciation methods generally are accelerated, with most assets being subject to 200% or 150% declining balance depreciation. I.R.C. §§ 168(b), (e) (Supp. IV 2005).

235. *Id.* § 168(k)(4). Bonus depreciation is discussed further *infra* note 246 and accompanying text.

236. *Infra* notes 239–40 and accompanying text.

237. *Infra* notes 241–45 and accompanying text.

238. However, some tax incentives would remain. For example, although GAAP limits depreciation to cost minus salvage value, accelerated depreciation methods are permitted. *See* ROBERT LIBBY ET AL., FINANCIAL ACCOUNTING 432–35 (3d ed. 2001) (noting that the 200% declining balance method is the most accelerated depreciation scheme allowable for financial reporting purposes).

239. I.R.C. § 48 (Supp. IV 2005).

240. *Id.* § 47.

241. *Id.* § 173.

242. *Id.* § 174.

243. *Id.* § 175.

244. *Id.* § 198.

245. *See e.g.*, *id.* § 179A (providing a deduction for the purchase of qualified clean-fuels vehicles).

capital expenditures.[246] Although one can argue that these incentives could be more efficiently delivered by other means, the loss of these incentives is an argument against taxing corporate income on the basis of GAAP. More to the point, Congress is unlikely to relinquish the opportunity to intervene, whether its focused incentives reflect special interest lobbying or rational responses to market failures.

b. Accounting Incentives

One might be tempted to think that the economic incentive problem could be solved by conforming book and tax at the tax end of the spectrum, rather than the GAAP end, in other words, by reporting taxable income to both investors and the IRS. But that is not the case. As we have seen, the empirical evidence indicates that accounting rules affect managerial behavior much as tax rules do, and contracting and agency theory explain why accounting rules have persistent incentive properties. Adopting the Internal Revenue Code for financial accounting would eliminate many implicit accounting incentives.

Reconsider depreciation. As noted above, today most firms utilize straight-line financial depreciation for most assets because, relative to the other GAAP alternatives, the method maximizes the present value of reported earnings.[247] Because managers are motivated to report high earnings, the option to employ earnings enhancing straight-line depreciation (relative to accelerated depreciation) can be viewed as a financial accounting incentive for capital investment.

If firms were required to utilize the tax depreciation rules in preparing their financial reports, their appetite for capital investment would be lessened. Under the accelerated depreciation methods generally used for tax, both first year expense and the total present value of reported expense associated with capital investment would increase substantially. For the reasons discussed in our consideration of the impact of book-tax conformity allowing for managerial discretion—essentially agency and other contracting cost explanations—this change would lead to deferral of capital investment or substitution away from capital investment at the margin.[248] In fact, there are two reasons to think that

246. The 30% bonus depreciation allowance applied to certain property acquired after September 10, 2001 and before May 6, 2003. I.R.C. § 168(k)(1), (4) (Supp. V 2005). The allowance was increased to 50% for property acquired after May 5, 2003, and placed in service before January 1, 2005. *Id.* § 168(k)(4).

247. *Supra* note 226 and accompanying text.

248. *Supra* Part V.C.1.b. In brief, all else being equal, accelerated expenses would increase the present value of the expected cost of violating floating GAAP debt covenants,

the behavioral effect of earnings would be greater in this scenario than in a realm of discretionary book-tax conformity. First, the survey conducted by Graham, Harvey, and Rajgopal indicates that executives are more likely to adjust operations to achieve earnings targets than they are to adjust accounting practices.[249] Second, the empirical evidence is at least consistent with the idea that managers are more sensitive to earnings effects when making discrete one-time decisions, such as capital investment decisions, than with respect to routine, ongoing matters.[250] Thus, the impact of eliminating implicit accounting incentives on operational decisions could be significant.

To be sure, the tax code permits firms to utilize straight-line depreciation,[251] but even this election would not fully eliminate the earnings hit from the change in rules, given nonelective tax rules related to salvage value and depreciation periods that also accelerate deductions.[252] Of course, any depreciation baseline is essentially arbitrary. There is no one correct depreciation technique that reproduces economic depreciation for all assets. But whether straight-line financial depreciation represents a subsidy or normality is unimportant, the point is that this and other gaps between GAAP and the tax code can be thought of as tax incentives, accounting incentives, or a mix of the two.

In many cases "GAAP incentives" are simply the flip-side of tax incentives. In other words, the financial accounting treatment may approximate economic reality, while the tax rules reflect subsidies. To some extent, this is the case for depreciation. Another example is the disparate treatment of municipal bond interest. The interest on such bonds generally is not included in taxable income,[253] providing a subsidy to state and local governments that are able to reduce their borrowing costs through the issuance of these bonds.[254] But the interest received is included in reported earnings.[255] Adopting a tax baseline for both tax and book purposes would preserve the tax incentive but

---

reduce the present value of earnings-based bonuses, and increase the likelihood of missing earnings targets in the year of investment.

249. *See supra* note 38 and accompanying text (discussing this finding).

250. *Supra* Part III.D.

251. I.R.C. § 168(b)(3)(D) (Supp. IV 2005).

252. *See id.* §§ 168(b)(4), (e) (stating that the salvage value is zero and setting forth a mandatory property classification table).

253. *Id.* § 103(a).

254. *See* GRAETZ & SCHENK, *supra* note 145, at 215–17 (noting that the subsidy is not perfectly efficient as part of the benefit is captured by high bracket taxpayers who invest in such bonds).

255. LIBBY ET AL., *supra* note 238, at 514.

introduce a financial accounting disincentive for corporations to purchase municipal bonds.

In other cases, GAAP permits income-increasing or income-accelerating accounting procedures relative to clearly more neutral treatments incorporated in the tax code. Examples include the failure to require expensing of compensatory stock options prior to 2006 and the recent elimination of the requirement to amortize purchased goodwill.[256] Because these deviations resulted from industry lobbying, it is not surprising that they are income enhancing. What is surprising is that they have not been recognized as incentives, although they should be. Conforming GAAP to the arguably more neutral tax treatment of these items would tend to discourage the use of compensatory options and discourage merger activity.

The bottom line is that whether an accounting rule can be said to be neutral and economically correct and the corresponding tax rule to be the deviation and the incentive, or vice versa, it is important to mind the gap. Eliminating the gap in either direction will reduce the tax incentive, create an accounting disincentive, or do some of both.

4. *Economic Consequences and Flexible Book-Tax Conformity*

The foregoing analysis suggests that reduction of the gap between tax and financial accounting would have adverse economic consequences however the gap is reduced. But it also suggests that if full conformity is the objective, how it is achieved matters. Allowing firms to choose the basis for conformity could minimize the adverse economic consequences. On the other hand, given flexibility, managers should be expected to make the earnings/tax tradeoffs that maximize their own utility, rather than shareholder value. On balance, it is unclear whether providing flexibility in book-tax conformity would benefit shareholders or not.

Individual company flexibility in achieving book-tax conformity is common. As we have seen, the one example of book-tax conformity currently in place in the United States requires consistency between LIFO and FIFO accounting for book and tax reporting, but leaves the choice up to individual

256. Nonqualified stock options result in a tax deduction equal to the amount of income recognized by the optionee in the year of option exercise. I.R.C. § 83(h) (Supp. IV 2005). Under I.R.C. § 197, purchased goodwill is amortized ratably over a fifteen-year period. *Id.* § 197(a). Under GAAP, purchased goodwill need only be recognized for financial accounting purposes to the extent that it is impaired. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 142, GOODWILL AND OTHER INTANGIBLE ASSETS 1, 11 (June 2001).

companies.[257] Similarly, German rules allow firms to choose between straight-line and accelerated depreciation, as long as they are consistent.[258] Moreover, these choices need not be binary. One can imagine permitting firms to select from a range of depreciation methods as long as internal consistency is maintained.

Shareholder-loyal managers could use such flexibility to minimize the adverse economic consequences of book-tax conformity. Firms that were relatively insensitive to reported earnings (because nonpublic or flush with cash) would select the conforming treatment that minimized taxes, such as accelerated depreciation. Firms that were relatively insensitive to taxes (because of large net operating losses) would select the conforming treatment that maximized earnings. Firms in between these extremes would trade off earnings maximization against tax minimization.

Well governed firms would make these tradeoffs with an eye towards maximizing share value. The concern, of course, is that managers of some firms would sacrifice taxes for earnings to a greater extent than necessary to optimize share value. Of course, even if conforming treatments are specified by Congress, many managers would utilize operational flexibility in the same way. However, adding flexibility in accounting treatments is likely to exacerbate the agency problem.

5. *A Note on Social Costs*

Recognizing that accounting rules have economic consequences does not necessarily mean that ignoring those consequences entails social costs. Should we care whether corporations minimize their taxes or whether implicit accounting incentives are eliminated through book-tax conformity? Yes, we should. First, failure to optimize taxes and maximize shareholder value results in reduced incentives to invest in equity securities and ultimately in reduced capital formation.[259] Second, in some cases, sacrificing tax benefits for earnings may directly result in inefficient allocation of resources. Imagine a manager faced with the option of selling a depreciated asset or spinning the asset off to shareholders. As in *Kamin*, sale would result both in a tax benefit and an earnings hit, and we will assume, would be in the shareholders' interest. Spinning off the asset to avoid the earnings hit not only sacrifices share value, it

---

257. I.R.C. § 472(c) (Supp. IV 2005).

258. *Supra* note 194 and accompanying text.

259. *Cf.* CLARK, *supra* note 171, at 274 (making a similar argument that insider trading acts as a tax on investors which may chill capital formation).

also may delay the transfer of the asset to a more highly valuing user.[260] Similarly, during the 1990s, managers probably over-utilized accounting-preferred stock option compensation when restricted stock or cash would have been more efficient.[261]

This final point may lead readers to question the social value of preserving other accounting incentives. I have argued that the incentives for investing in capital assets would be lessened by conforming book and tax depreciation conventions, but this is troubling only if one believes that such incentives are necessary or appropriate. The pre-2005 stock option rules probably were neither, but the stock option "incentive" was somewhat inadvertent, and the situation may be quite different with respect to other provisions. Consider capital investment incentives. Congress apparently believes that certain capital investment incentives are appropriate, enacting various general and specific tax incentives for investment from time to time. The overall level of corporate investment depends as much on the financial accounting rules concerning investment as on Congress's explicit tax incentives. Thus, we should be wary of undermining the overall scheme by eliminating implicit accounting incentives for investment.

D. *Further Book-Tax Conformity Alternatives and Alternatives to Conformity*

Full book-tax conformity is problematic from an economic consequences perspective. Better from this standpoint are partial book-tax conformity proposals, such as the idea of utilizing a GAAP baseline with specific tax deviations adopted by Congress. For example, Mitchell Engler has proposed a more nuanced approach to book-tax conformity that would maintain intended tax incentives, such as accelerated depreciation, while closing pernicious gaps.[262] Maintaining the disparate treatment of depreciation for tax and book purposes would maintain current tax and accounting incentives. Further, compared to the German flexible depreciation model, this proposal would limit the extent to which managers would inappropriately sacrifice taxes for reported earnings. The problem, of course, is identifying the pernicious gaps. Almost

260. The paradigm case would be the spin-off of a corporate division as a new publicly traded corporation managed by individuals who were formerly part of the parent company's management team. Ultimately, this former division may be absorbed by a higher valuing user, in which case, the intermediate spin-off simply postponed the efficiency-enhancing transition.

261. *Supra* Part III.C.

262. *See* Engler, *supra* note 190, at 599–600 (concluding that a limited approach to book-tax conformity could compensate for the shortcomings of a more comprehensive approach).

all deviations between GAAP and the tax code result in tax and/or accounting incentives. And, of course, as Hanlon and Shevlin have argued, the stability of partial book-tax conformity is open to question.[263]

Although, at first blush, increased book-tax conformity seems to be an attractive approach to combating tax sheltering and artificial earnings inflation, commentators have pointed out numerous problems with proposals for enhanced conformity. The adverse economic consequences of increasing book-tax conformity, whatever the method, add to the arguments against adopting this tool and in favor of other means of attacking these problems, principally enhanced disclosure and reconciliation of book-tax differences.[264] Detailed consideration of the merits of these alternatives is beyond the scope of this Article, but it is worth noting that unlike increased book-tax conformity, enhanced disclosure and reconciliation would add to the information available to the market and would have little or no economic consequence. Like footnotes to accounting statements, the tax reconciliation reports would have no affect on reported earnings or taxes paid. Of course, mandating more extensive reconciliations would increase rather than decrease compliance costs, but given the adverse economic consequences of book-tax conformity and other drawbacks, disclosure and reconciliation may be the superior approach.

VI. Instrumental Accounting

This final Part considers a series of related policy questions that are prompted by recognition of the economic consequences of accounting standards, as outlined in the previous Parts: If earnings-decreasing shifts in GAAP made to increase book-tax conformity would have adverse economic consequences, would earnings-increasing adjustments to GAAP have positive economic consequences? Book-tax conformity aside, should we consider the economic consequences of accounting in the standard-setting process? More affirmatively, should accounting standards be used instrumentally as a means of encouraging investment or otherwise shaping corporate behavior, as an alternative to tax incentives, direct subsidies, and legal mandates?

Of course, there would be drawbacks to adopting accounting standards that deviate from economic accounting, but in a second-best world, they might serve as a valuable addition to the public policy toolbox. Financial accounting incentives could provide powerful levers for shaping corporate behavior and

263. *Supra* note 207 and accompanying text.

264. *See generally* Mills & Plesko, *supra* note 186 (proposing revisions to the tax schedules used to reconcile tax and book income).

could mold the behavior of organizations indifferent to tax incentives. However, the costs would be significant as well. Embracing instrumental accounting would open up the standard-setting process to lobbying and potential capture by the interest group with the most at stake—corporate management. In addition, purposeful deviation from economic accounting would diminish the usefulness of accounting reports to investors and other users. This final Part briefly considers the potential benefits and costs of instrumental accounting. Although an omniscient and benevolent power could increase social welfare through the use of explicit accounting incentives, Congress is not such a power, and this Part tentatively concludes that social welfare is probably maximized by minimizing Congress's role in accounting and leaving the FASB to achieve, as well as it can, "neutral" standards of accounting.

A. How Would Instrumental Accounting Work?

Instrumental accounting would entail designing substantive financial accounting standards with a view towards shaping managerial, and thus corporate, behavior. Analogous to tax incentives and penalties, accounting incentives and penalties would represent purposeful deviations from ideal or "economic" accounting standards, i.e., standards that result in income figures that most closely approximate real world results. Historically, the FASB has rejected deviations from economic accounting for the purpose of providing incentives.[265] This is not to say, however, that current accounting standards always match economic accounting. Achievement of ideal accounting standards is limited by at least two factors. First, the fundamental principal of conservatism results in a bias in favor of early recognition of expense and deferred recognition of income versus economic accounting.[266] Second, ideal accounting would be prohibitively costly. Given the almost infinite variety of circumstances encountered by businesses, some simplifying rules of recognition must be employed to make the system operable.[267] Within these constraints, however, the FASB has sought to approximate economic accounting.

---

265. *See* FACTS ABOUT FASB, *supra* note 197, at 1 (providing FASB's mission statement).

266. *See* Ross L. Watts, *Conservatism in Accounting: Part I: Explanation and Implications*, 17 ACCT. HORIZONS 207, 208 (2003) (examining alternative explanations for and implications of conservatism in accounting, which at the extreme is defined by the adage "anticipate no profit, but anticipate all losses").

267. Consider depreciation expense. Economic depreciation would reflect the estimated reduction in value of a depreciable item year by year and would be highly idiosyncratic. Because the cost of determining and maintaining hundreds or thousands of separate depreciation

However, the potential for financial accounting incentives is plain. As an example, let us again return to depreciation. As noted in the previous Part, shifting from straight-line to accelerated financial depreciation would result in a reduction in the present value of reported earnings, thereby discouraging capital investment. Suppose, however, that Congress were to direct the SEC to permit *decelerated* financial depreciation for a certain class of assets.[268] Businesses purchasing these assets could adopt a depreciation schedule that would result in even greater reported income in early years (because of smaller deductions in early years), with offsetting reductions in income in later years, compared against straight-line depreciation. Given all of the incentives discussed in previous Parts for managers to increase the present value of reported earnings, the option to adopt decelerated financial depreciation should spur investment in this class of assets.[269]

The recent treatment of employee stock options suggests an even more direct means of providing accounting incentives—permitting companies to simply "footnote" the relevant expense rather than reducing reported earnings. Suppose, for example, that Congress wished to spur corporate charitable contributions. These contributions are deductible for corporate tax purposes,[270] but many corporations pay little or no tax due to losses incurred in previous years, other tax incentives that they have embraced, and in some cases, questionable tax shelters.[271] Moreover, the

---

schedules for the various vehicles, pieces of equipment, and structures owned by a business would be prohibitive, financial accounting standards provide for a limited menu of depreciation schedules.

268. Decelerated, or sinking fund, depreciation involves relatively small depreciation deductions initially that increase over the useful life of the asset. Decelerated depreciation matches economic depreciation for assets that suffer an increasing annual decline in value over their useful lives.

269. In brief, and all else being equal, postponing expenses would reduce the present value of the expected cost of violating floating GAAP debt covenants, increase the present value of earnings-based bonuses, and reduce the likelihood of missing earnings targets in the year of investment. CFOs interviewed by Graham, Harvey, and Rajgopal report being much less concerned about achieving earnings targets down the road than in the present quarter. Graham et al., *supra* note 38, at 20. Their hope is that their firms will grow sufficiently to deliver greater earnings in future periods. *Id.* This optimism nicely supports the efficacy of significantly decelerated financial depreciation as an incentive. In the year of the investment (and probably the decision), the reduction in net income would be very small and unlikely to threaten achievement of targets. The real hit to earnings from the expenditure would arise in future periods when optimistic executives would expect sufficient earnings from operations to cover the depreciation expense. To be sure, as Dan Shaviro notes in a recent paper, accounting incentives aimed at investment could produce a clientele effect but no overall effect on activity if the marginal investor does not value the earnings benefit. *See* Shaviro, *supra* note 185, at 37.

270. *See* I.R.C. §§ 170(a), (b)(2) (Supp. IV 2005) (authorizing deductions for corporate charitable contributions but limiting the amount deductible to 10% of a corporation's taxable income).

271. *See* U.S. GEN. ACCOUNTING OFFICE, COMPARISON OF THE REPORTED TAX LIABILITIES

tax deduction will only go so far in spurring contributions by even tax paying businesses. Thus, Congress might decide that further incentives are in order. Suppose that Congress were to permit companies to refrain from "expensing" qualifying contributions, as long as the contributions were fully disclosed in a footnote to the financial statements, just as stock option expense was footnoted between 1995 and 2005. The result, of course, would be that charitable contributions would be free from an accounting perspective, and much more attractive to managers. Obviously, this footnoting technique could be used with virtually any current corporate expense that Congress wished to encourage, such as the cost of employer provided health care (either in place of or in addition to the current tax incentive), qualified pension contributions, etc.

B. Advantages of Instrumental Accounting

Accounting incentives would appear to be powerful and flexible devices for shaping corporate behavior. Are there other advantages to utilizing accounting incentives in lieu of tax incentives, direct subsidies, or mandates? At first blush, the fact that accounting incentives do not drain the public fisc (as direct subsidies or tax subsidies do) would seem to be a large advantage, but on closer review this factor does not yield a social benefit. The real advantage of accounting incentives would probably lie in their ability to complement tax incentives.

Replacing tax incentives or direct subsidies with accounting incentives would reduce the burden on the public fisc. As Surrey pointed out, direct governmental subsidies and tax incentives have an equivalent impact on the public fisc.[272] Replacing a tax incentive, such as accelerated tax depreciation, with a direct subsidy that returns the same aggregate dollars to the eligible businesses would have no overall effect on tax rates because the additional tax revenues raised by eliminating the tax incentive would be needed to fund the direct subsidy.[273] On the other hand, replacing either a tax incentive or a direct subsidy with an accounting incentive reduces the burden on the public fisc.

OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1996–2000, at 2, 9 tbl.1 (2004) (reporting that 63% of all U.S.-controlled corporations and 45.3% of large U.S.-controlled corporations (defined as those with at least $250 million in assets or $50 million in gross receipts) reported no federal income tax liability for the year 2000).

272. *See* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 726 (1970) (comparing the impact of direct government assistance and tax incentives on the economy).

273. *Id.*

This property of accounting incentives is shared by tax *penalties*. Encouraging businesses to do *X* by taxing the alternative *Y* also appears to be fisc-friendly, but the reduced drain on the fisc does not necessarily translate into a social benefit in either case. This is because the direct subsidy or tax incentive represents a transfer, as well as an incentive.[274] Of course, Congress may prefer incentives that are not accompanied by transfers, such as tax penalties and accounting incentives, because these devices mask the appearance of larger government, but analysts need to avoid being taken in by the illusion.[275]

Rather than focusing on the direct impact on the public fisc, the appropriate way to evaluate accounting incentives relative to the alternatives is to consider the efficiency with which the incentive is delivered. The empirical evidence suggests that firms are quite sensitive to accounting considerations, but it is difficult to assess the relative sensitivity of firms to accounting, tax, and direct subsidies. Contracting and agency theory tell us that corporate sensitivity to accounting incentives would vary significantly depending on company leverage, size, executive compensation design, corporate governance, and other factors that influence managerial sensitivity to reported earnings. Of course, corporate sensitivity to tax incentives varies as well, and a mix of tax and accounting incentives potentially could be optimal. Firms that are flush with cash and profits may be relatively insensitive to reported earnings but quite sensitive to tax incentives, while firms that are unprofitable and nearing financial distress may be relatively insensitive to tax incentives but highly sensitive to earnings-increasing accounting choices.[276] However, the overall efficiency of instrumental accounting is reduced by the factors discussed in the next several sections.

---

274. *See generally* Louis Kaplow, *On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy*, 18 J. ECON. PERSP. 159 (2004).

275. *Cf.* Daniel N. Shaviro, *Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, 45 B.C. L. REV. 1285, 1304 (2004) (arguing that the notion that the Bush tax cuts shrank the size of government rests on a spending illusion that confuses the nominal flow of dollars between the government and individuals with the actual impact of the government on the economy).

276. As discussed *supra* note 271, a majority of U.S.-controlled corporations reported no tax liability for 2000. However, because corporate tax losses can be carried forward and back in time, a company reporting no tax liability for a particular year is not necessarily insensitive to tax incentives. *See* I.R.C. § 172 (Supp. IV 2005) (providing for net operating loss carryovers and carrybacks). In addition, some tax incentives may be transferred (i.e., sold) to firms that have positive tax liabilities. *See, e.g.*, David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent*, 53 TAX LAW. 579, 581–82 (2000) (discussing certain leasing transactions having a primary purpose of shifting tax benefits that are permissible under current tax rules and judicial doctrine).

C. The Costs of Instrumental Accounting

Embracing explicit accounting incentives as a regular tool of public policy would result in numerous dislocations and costs. First, although positive accounting theorists focus on contracting costs from an issuer's perspective, there are other parties to these contracts. Earnings-increasing changes in standards could result in some shifting of wealth from creditors to debtors. Second, instrumental use of accounting standards necessitates accepting deviations from accounting rules that most closely reflect the economic reality of various transactions. Such deviations entail costs arising from degradation of the information content of financial statements. Third, shifting the venue of some governmental economic intervention to the accounting arena would result in a shift and perhaps an increase in lobbying activity, and we might worry whether the standard-setting process would be particularly susceptible to regulatory capture. Fourth, incorporating explicit accounting incentives into U.S. GAAP could undermine international convergence of accounting standards. Finally, there are a number of inefficiencies associated with providing incentives through the tax code, such as misplaced administrative responsibility, that might also apply to accounting incentives.

1. Impact on Corporate Creditors

Under the debt covenant theory, an accounting standard change that increases/decreases reported earnings, loosens/tightens sticky covenants, leading to an indirect increase/decrease in the share price of leveraged firms affected by the accounting change. Of course, there is another party to these debt covenants, the lender, and to some extent the shareholders' gains or losses are offset by losses or gains to the lender. Imagine an accounting standard change that decreases reported earnings, pushing a corporation closer to violation of its debt covenants and costly default. Clearly this is costly for the firm, but the lender may benefit. Companies may take other steps that reduce the risk of default that they would not otherwise have taken. In other words, companies may reduce the risk of actual default to offset the increased risk of technical default arising from the change in standards, and that benefits the lender. Positive accounting theory suggests that there will be an overall economic loss in this situation. Presumably, the corporate borrower and lender negotiated the ideal debt covenant based on previous accounting standards and the change in standard results in a suboptimal outcome. Nonetheless, the net economic loss is likely to be less than the loss to the shareholders.

By the same token, an earnings-increasing change in accounting standards pushes debtor corporations further from the brink of insolvency, reducing the expected cost of technical default, but because the standard change has no effect on the risk of actual default, the change undermines the protection afforded by the debt covenants, which is costly to lenders. Again, this is unlikely to be a "zero-sum" effect, assuming, reasonably, that renegotiation of the covenants is not costless. The point, however, is that there is no free lunch. The benefit to debtors from earnings-increasing standard changes is costly to lenders.

However, these effects are likely to be modest. As noted above, corporate borrowers and lenders increasingly appear to be basing debt covenants on a mixture of GAAP and non-GAAP rules or locking the rules into place at the time covenants are negotiated.[277] Adoption of instrumental accounting as a regular tool of public policy would likely lead to an acceleration of that trend.[278]

2. *Degradation of the Usefulness of Financial Reports*

There is an old debate in the academic accounting literature as to whether nonaccounting social welfare effects should be taken into account in setting standards. The accounting purists argued that the "economic consequences" of accounting standards should be ignored, that the rules should be as neutral as possible and avoid "influencing behavior in any particular direction."[279] The concern of the purists was that adjusting standards to reflect nonaccounting consequences would lead to a loss of credibility and confidence in GAAP.[280]

Opposed were academics who believed that accounting neutrality was unattainable,[281] that standard setters historically had considered nonaccounting

---

277. *Supra* note 52 and accompanying text.

278. Of course, a move in this direction undermines one of the potential explanations for the behavioral power of accounting. However, as discussed in Part IV.C, *supra*, the debt covenant hypothesis may not be the most persuasive explanation for corporate response to accounting rules over the long haul.

279. FACTS ABOUT FASB, *supra* note 197, at 2. *See also* DAVID SOLOMONS, MAKING ACCOUNTING POLICY 233–35 (1986) (arguing the importance of accounting neutrality); Victor H. Brown, *Accounting Standards: Their Economic and Social Consequences*, 4 ACCT. HORIZONS 89, 95–96 (same).

280. Brown, *supra* note 279, at 94. *See also* SOLOMONS, *supra* note 279, at 232 ("[I]n the long run accounting can retain its credibility only if it does what it is designed to do—provide society with relevant and reliability information about economic events and transactions—and does not attempt to move the economy in one direction rather than another.").

281. *See* David M. Hawkins, *Financial Accounting, the Standards Board and Economic Development*, SAXE LECTURES IN ACCT., Nov. 12, 1973, http://newman.baruch.

"economic consequences" in promulgating rules,[282] and that it was the affirmative obligation of the standard setter to take these economic consequences into account.[283] This debate has quieted in recent years, and it would appear that the purists won the aspirational battle, at least. Recent FASB statements uniformly embrace the economic neutrality objective.[284] The only "economic consequence" recognized by the FASB as having a legitimate role in standard setting is the economic benefit of changes "that result[] in financial statements that are more relevant and representationally faithful, and thus more useful for decision making."[285]

Although unstated, presumably the central concern of the GAAP purists was that a loss of credibility or confidence in GAAP would be costly. If audited financial statements become less credible, reliable, or useful as a result of consequential changes in standards, users of these statements would be forced to seek alternative sources of data, negotiate more protective agreements, or simply accept greater risk in dealing with an issuer, all of which is costly.

As highlighted by recent literature from the book-tax conformity debate, the more general worry is that departures from financial accounting neutrality would have adverse effects on the value-relevance of financial statements.[286] However, not all departures from existing financial accounting standards are equally problematic. For example, Hanlon and Shevlin consider the effect on conforming depreciation techniques, specifically using the accelerated tax depreciation rules for financial reporting. In this case, they argue that the change would result in a "minimal" loss of information "because economic depreciation of an asset does not follow either [the tax or book depreciation method] exactly."[287]

---

cuny.edu/digital/saxe/saxe_1973/hawkins_73.htm (arguing that all accounting standards influence economic behavior) (on file with the Washington and Lee Law Review).

282. *See* Stephen A. Zeff, *The Rise of "Economic Consequences,"* 146 J. ACCT. 56, 58 (1978) (providing examples of accounting rules being influenced by economic consequences).

283. *See* Hawkins, *supra* note 281 ("[B]ecause the Standards Board has the power to influence economic behavior it has an obligation to support the government's economic plans.").

284. *See, e.g.*, FACTS ABOUT FASB, *supra* note 197, at 2 (stating as an objective of the board that it "ensure . . . the neutrality of information resulting from its standards").

285. FIN. ACCOUNTING STANDARDS BD., EXPOSURE DRAFT: PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS: SHARE-BASED PAYMENT, app. c para. C34 (Mar. 2004), *available at* http://www.fasb.org/draft/ed_sbp_appc.pdf (on file with the Washington and Lee Law Review).

286. *See* Hanlon et al., *supra* note 190, at 2 (arguing that value relevance could be undermined "if standard setting and GAAP is captured by tax rule-makers, policy makers, and politicians").

287. Hanlon & Shevlin, *supra* note 12, at 29.

More generally (and obviously), deviating from neutrality in order to provide accounting incentives results in costly information loss to the markets only if information is truly lost. As long as the standards are unambiguous, shifting from straight-line financial depreciation to some explicit decelerated depreciation method should have minimal informational impact. Even more clearly, shifting an expense from income statement to footnote should have no impact on information, just as shifting options expense from the footnotes to the income statement will have no informational impact.[288]

Thus, while deviating from neutral accounting principles in order to provide incentives would inevitably result in some degradation in the value-relevance of financial statements, the impact could be limited by focusing on the presentation of information, i.e., shifting expenses to footnotes, and maintaining the overall substance of the information provided.[289] Adverse impact could be limited further by being highly selective in adopting the instrumental accounting approach. For example, given the inherent difficulty of matching depreciation schedules to economic depreciation, the informational cost of adjusting financial depreciation schedules to spark investment might be modest. Overall, the impact of limited deviations that are carefully implemented to preserve as much value-relevant information as possible would likely be small.

3. Lobbying, Regulatory Capture, and the Quality of Accounting Incentives

Given the fundamental economic policy issues at stake, instrumental accounting should be a tool utilized only by Congress, if at all. The FASB has quite correctly refused to consider economic consequences in its standard-setting process. A private body of accountants is not equipped to weigh nonaccounting issues and has no access to the competing means of economic intervention available to Congress. Thus, embracing instrumental accounting would entail relocating some responsibility for the standard-setting process

288. Keep in mind that there may be other costs or benefits associated with these adjustments, such as contracting cost effects, but the claim here is that these cosmetic changes need not result in degradation of information made available to the market. For example, shifting an expense from earnings statement to footnote for instrumental purposes should not be interpreted by the market as a signal that the information has become less important or reliable.

289. One might argue, and it could be true, that an earnings-increasing accounting incentive would be less effective if the only change was to shift an expense from the body of the financial statement into a footnote providing a pro forma earnings calculation undoing the change. However, this has been the situation with stock option expensing over the last decade, and that "incentive" has been very successful.

from the FASB to Congress. Primary responsibility could remain with the FASB, with Congress intervening from time to time with respect to particular standards, or following the tax model, primary responsibility could be shifted to Congress with implementation entrusted to a governmental agency or perhaps the FASB. In either scenario, however, we should expect increased lobbying over standards, worry about the potential for capture by managerial interests, and question the quality of instrumental standards that would be promulgated. While a benevolent, disinterested, and omniscient social planner could make positive use of instrumental accounting, the politics of standard setting should lead us to question whether adding instrumental accounting to the regulatory tool-kit would increase or decrease social welfare.

There is certainly reason to be concerned about lobbying costs and regulatory capture if instrumental accounting were to become the norm. Corporate managers would have a very strong interest in lobbying Congress (and whatever committees Congress empowered to oversee financial accounting) for earnings-increasing standards, and it is not at all clear that there would be any effective lobbying interests countering them.[290] Creditors would be hurt by earnings-increasing standards that undermined the protection of debt covenants, but dispersed bond holders, for example, should not be expected to form an effective lobby. Moreover, although auditors and accountants certainly have an interest in accounting standards, they are more likely to be concerned about the consistency and ease of administration of the rules than their substance.

Accounting commentators have worried that eliminating economic neutrality as a guiding principle of the standard-setting process would lead to a lobbying frenzy and severely undermine principled standard setting.[291] That is not to say that lobbying does not occur today or that it is totally ineffective. There is evidence that corporations effectively lobby the FASB.[292] But casual

---

290. For a brief discussion of the determinants of lobbying effort and expenditure, see *supra* note 211 and accompanying text.

291. *See* David Solomons, *The Political Implications of Accounting and Accounting Standard Setting*, 13 ACCT. & BUS. RES. 107, 114 (1983) (noting "general agreement among accountants that anything that can limit the area of political disagreement in accounting will be beneficial"); Hanlon et al., *supra* note 190, at 37 (suggesting that Congress as a political body would be more susceptible than the FASB to lobbying); Press Release, Fin. Accounting Standards Bd., Financial Accounting Foundation Trustees Issue Statement Opposing Legislative Proposals to Curb FASB Independence (June 14, 2004) (voicing concern regarding "Congress send[ing] the message that special interests are able, through legislation, to overturn expert accounting judgment") (on file with the Washington and Lee Law Review).

292. *See* Brown & Feroz, *supra* note 208, at 727–29 (finding that the FASB is influenced by corporate comment letters and that larger corporations have more influence than smaller ones); *see also*, Edward B. Deakin, *Rational Economic Behavior and Lobbying on Accounting*

observation suggests that corporate lobbying with respect to accounting standards does not approach lobbying of tax writers. Perhaps that is because managers care more about taxes than reported earnings, but I strongly doubt it. It is more likely that the difference arises from the belief that the FASB, with its focus on neutrality, rejection of nonaccounting policy considerations, and insulation from the electoral process, is less susceptible to lobbying than Congress.[293]

Congress has rarely intervened in the standard-setting process, but its occasional interventions give us some clues about the welfare implications of instrumental accounting. Two examples demonstrate the promise and the peril. One of the most significant interventions by Congress and the SEC in substantive standards occurred in the early 1960s after Congress enacted an investment tax credit.[294] Although the tax legislation provided for immediate "flow-through" tax benefits, the Accounting Principles Board (the FASB's predecessor) issued an opinion requiring, for financial reporting purposes, that the tax benefits be spread over the lives of the assets purchased.[295] That conservative approach reduced the favorable earnings impact of the tax legislation (versus a parallel flow-through financial accounting approach). The accounting profession was split on the proper treatment, but business leaders lobbied hard for flow-through accounting.[296] The SEC took the unusual step of overturning the APB's opinion with its own opinion allowing either accounting method to be used.[297] About a decade later, Congress enacted a new version of the investment tax credit and specified in the legislation that either accounting approach would be acceptable—a rare case of Congress engaging in instrumental accounting.[298] In my view, these

Issues: Evidence from the Oil and Gas Industry, 64 ACCT. REV. 137, 150 (1989) (investigating lobbying on accounting for oil and gas producing activities and finding that contracting and cash flow effects were correlated with lobbying activity).

293. According to the economic theory of regulation, lobbying expenditure is a function of the potential payoff from lobbying. *Supra* note 211 and accompanying text. All else being equal, the expected return on lobbying a more compliant regulator is greater than the return on lobbying a less compliant regulator.

294. *See* Gary John Previts & Dale L. Flesher, *A Perspective on the New Deal and Financial Reporting: Andrew Barr and the Securities Exchange Commission, 1938–1972*, 23 BUS. & ECON. HIS. 221, 226 (1994) (discussing the controversy over the 7% investment tax credit enacted under President John Kennedy).

295. *See* Joel Seligman, *The SEC and Accounting: A Historical Perspective*, *in* THE SEC AND ACCOUNTING: THE FIRST 50 YEARS: 1984 PROCEEDINGS OF THE ARTHUR YOUNG PROFESSORS' ROUNDTABLE, *supra* note 193, at 19 (discussing the "flow-through" and deferral methods of accounting for the tax credit); Previts & Flesher, *supra* note 294, at 221 (discussing the Accounting Principles Board's reaction to the tax credit).

296. *See* Seligman, *supra* note 295, at 19 (documenting a split of opinion among the "Big Eight" accounting firms between the flow-through and the deferral methods).

297. *Id.*; Previts & Flesher, *supra* note 294, at 226; Solomons, *supra* note 291, at 117.

298. Previts & Flesher, *supra* note 294, at 226.

were positive interventions. By permitting flow-through accounting of the tax benefits, Congress and the SEC boosted the incentive provided by the investment tax credit with little loss of information to the financial markets.

The other example involves only threatened intervention and takes us back to the stock option expensing story. As discussed above, the FASB struggled for a decade before successfully implementing a requirement that stock option expense be recognized consistently with other forms of compensation. Corporate interests strongly resisted this earnings-reducing change in standards and several times enlisted the help of various members of Congress in pressuring the FASB to slow or water down its proposals. To be fair, other members of Congress supported the FASB's efforts, but had the primary responsibility for this standard rested with Congress, I have no doubt that the corporate interests would have prevailed. Expensing stock options will discourage their use and the new standard can be seen as an unwarranted brake on a popular compensation technique. In my view, the old option expense footnoting regime provided an inappropriate accounting preference for one particular type of compensation, leading to inefficient distortions in pay practices, i.e., over-reliance on options, and a particular form of options at that. The problem, of course, is that this story is not about a difference of opinion regarding the merits of stock options, it is about managerial interests that differ from shareholder interests and the likelihood that Congress will cater to management interests.

In my view, the problem of regulatory capture and the resulting likelihood that a Congress that embraced instrumental use of accounting standards would produce as many poor standards as good ones probably dooms the enterprise. Perhaps this is an unduly pessimistic view of Washington, but the view seems warranted. Of course, one can make the same point about tax incentives. The difference is that congressional involvement in the tax writing process is inevitable. That is not the case with the financial standard-setting process, but more on that after we consider a few other potential costs and benefits of instrumental accounting.

4. *Institutionalization of the Importance of Reported Earnings*

The idea behind instrumental accounting is to harness managers' irrational or rational but self-serving bias, which inflates the importance of reported earnings, in order to shape corporate behavior and increase social welfare. There is an inherent perversity in this idea, in that shareholder welfare would be increased if managers could be educated or disciplined into abandoning the bias in the first place. One might be concerned that explicit introduction of accounting incentives into GAAP would somehow institutionalize managers' earnings fixation and lead us further from the happy day in which managers fully understand and internalize the ECMH and positive accounting theory.

5. Conflict with International Convergence of Accounting Standards

In 2002, the FASB and the International Accounting Standards Board entered into a memorandum of understanding pledging to work towards "high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting."[299] Currently, no single set of accounting principles exists that is generally acceptable in all capital markets, and international convergence would result in obvious efficiencies.

Incorporating explicit accounting incentives into U.S. GAAP could undermine efforts to achieve international accounting convergence. For example, financial depreciation schedules that were regularly adjusted to fine-tune the incentives for U.S. companies to invest in certain asset classes would be problematic for convergence and add to the administrative burden of foreign firms attempting to list their shares on U.S. markets.

Without attempting to fully resolve this issue here, a number of observations are in order. First, it would appear that the negative effect on international convergence could be minimized by limiting accounting incentives to a few discrete issues, such as financial depreciation, and by implementing the incentives in such a way as to avoid information loss, e.g., by employing the stock option "footnoting" technique. These are the same techniques that were suggested above as a means of minimizing the loss of information in deviating from economic accounting, so introduction of the international convergence issue simply reinforces the reasons for cabining accounting incentives. Second, it should be noted that calls for increased book-tax conformity raise the same issue unless one believes that the systems would be conformed at economic accounting, which seems unlikely. In both cases, the reduction in international convergence is a cost of the proposal that must be weighed against the benefits.

6. Other Costs (and Benefits) of Instrumental Accounting

In a number of important articles and books, Stanley Surrey and Paul McDaniel exposed the inefficiencies of providing business incentives through the

---

299. Memorandum of Understanding, The Norwalk Agreement 1 (Sept. 18, 2002), http://www.fasb.org/news/memorandum.pdf.

tax system rather than through direct subsidies.[300] Accounting incentives would share many, but not all, of these inefficiencies.

One of Surrey and McDaniel's primary complaints was that tax incentives bypass the congressional committees and regulatory agencies that have the relevant subject matter expertise, e.g., agriculture, manufacturing, etc.[301] Not only is there a loss of expertise when this occurs, but a loss of coordination. Assuming that Congress patterned accounting incentive institutions on the tax model, this complaint would be equally valid. Of course, this institutional framework is not inevitable. Congress could decide that the various subject matter committees could employ accounting incentives as a policy tool in coordination with direct subsidies and other incentives. This alternative approach could result in the opposite coordination problem, different committees imposing different or conflicting accounting standards. This is not the place to work out a detailed regulatory scheme for the promulgation of accounting incentives, but two points should be emphasized: Coordination problems and loss of expertise might arise in the promulgation of accounting incentives, but the problems inherent in the tax model potentially could be mitigated.

Another complaint was that tax incentives were open-ended.[302] Unlike direct subsidies that had to pass through an appropriations process every year, tax incentives, once enacted, historically remained in force until they were eliminated or revised by future legislation. In recent years, this has begun to change. In order to hold down deficit projections, tax subsidies increasingly are enacted for a limited period and must be affirmatively renewed to continue in force.[303] Because accounting incentives have no direct effect on the public fisc, it is likely that accounting incentives would be open-ended like tax incentives were historically.

A further concern was that tax incentives damage the tax system through introducing complexity and inconsistency.[304] This risk would exist for accounting incentives as well. Ideally, Congress would impose just a few

---

300. *See generally* STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985); STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973); Surrey, *supra* note 272.

301. SURREY & MCDANIEL, *supra* note 300, at 106; Surrey, *supra* note 272, at 728.

302. Surrey, *supra* note 272, at 729–30, 730 n.34.

303. *See, e.g.*, I.R.C. § 168(k) (Supp. IV 2005) (titled "Special [Depreciation] Allowance for Certain Property Acquired After September 10, 2001, and Before January 1, 2005").

304. *See* SURREY & MCDANIEL, *supra* note 300, at 105–06 (arguing that "[m]uch of the complexity of our tax law derives from the tax expenditure provisions"); Surrey, *supra* note 272, at 731–32 (suggesting that introducing tax incentives results in a "blurring of concepts and objectives").

narrowly tailored accounting incentives that were designed to preserve relevant financial information while encouraging worthwhile economic behavior. But it is entirely possible that once the camel's nose breached the tent, we would wind up with a volume of accounting standards that rivaled the tax code. This issue is sufficiently serious that it is discussed more fully in the next section.

Accounting incentives would be similar to tax incentives in other ways. Both mechanisms generally are very blunt tools for economic intervention. Consider the corporate deduction for charitable contributions. For firms paying tax at the top marginal rate, this deduction amounts to a 35% governmental subsidy for charitable gifts. Is it likely that Congress actually thinks that 35% is the right level of subsidy? Why not 25% or 50%? And what about the startup firm with tax losses that can be carried forward for many years? The effective subsidy in that case rapidly approaches zero. Is that what Congress intended? In some cases, principally tax depreciation and investment tax credits, Congress has actively managed tax incentives. More often than not, however, they serve as a very blunt instrument.

Accounting incentives would suffer from the same defect. Decelerated financial depreciation could be fine tuned based on experience, but shifting an expense from income statement to footnote would have a dollar for dollar impact on reported earnings, whether this level of earnings impact would provide the right level of incentive or not.

On the other hand, tax and accounting incentives share an advantage with direct subsidies relative to legal mandates in allowing for heterogeneous responses. Assuming that Congress merely wants to encourage an activity and not require it, tax and accounting incentives, as well as direct subsidies, allow businesses to determine whether the carrot is sufficiently attractive to merit the change. However, all of these pros and cons are simply further factors to be taken into account in determining whether instrumental accounting is a viable tool for implementing government policy in a second-best world.

D. Thinking about Accounting Incentives in a Second-Best World

It may be useful to think about accounting incentives in the context of the tax simplification debate. The issues are similar. Undoubtedly, the tax system could be more efficiently administered if stripped of various economic incentives such as the home mortgage interest deduction, the deduction for charitable contributions, the earned income tax credit, and the exclusion for employer provided health insurance. But we live in a second-best world. Assuming one believes that government has a legitimate role to play in shaping economic behavior (or even if one believes that government inevitably will play that role whether it is legitimate or not), the appropriate question is what combination of tax rules, legal mandates, governmental spending programs, and, perhaps, accounting standards, most efficiently raises the revenue, shapes the behavior, delivers the services, and provides the information. Congress only has so many levers it can use to direct economic behavior. None is cost-free.

David Weisbach and Jacob Nussim have recently made this point with respect to tax incentives. As they say, "The government will, sometimes for the better and sometimes for the worse, subsidize, penalize, or regulate various activities, and we must decide how this should be done."[305] They argue that it is a mistake to focus narrowly on the effect of tax incentives on the complexity and efficiency of the tax code; rather, one must consider broader institutional design considerations in determining whether it is appropriate to deliver incentives through the tax code.[306]

A similar argument could be made for instrumental use of accounting. Accounting researchers bemoan potential degradation of financial information, but there is no reason to think that maximum value-relevance of financial statements should supersede all other considerations. But there is also a fundamental difference between accounting and tax. Congressional involvement in the federal tax system is irretrievably entrenched (if not unavoidable), and thus lobbying and regulatory capture problems in this arena are endemic. This is not true of financial accounting. With one or two exceptions, Congress historically has not involved itself with substantive accounting rules. We should, therefore, think twice before inviting the camel's nose into this particular tent. While one can dream of an all-wise and wholly public-spirited Congress tweaking one or two accounting rules to provide helpful incentives to business, the nightmare scenario of one-off, special interest driven accounting rules looms large. As noted above, the constituency with the greatest interest in accounting standards and strongest incentive to lobby is corporate management.[307] The concern, then, is not that inefficient governmental economic intervention would simply shift from tax incentives or direct subsidies to accounting incentives, but that opening up a new venue for intervention would result in incremental social costs, including increased lobbying and regulatory costs, that offset the advantages instrumental accounting would provide.

---

305. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 964 (2004).

306. *Id.* at 958–60.

307. *Supra* Part VI.C.3.

Still, given the behavioral power of financial accounting standards, it is tempting to propose limited consideration of accounting incentives, perhaps as a tie-breaker in situations in which the proper accounting treatment of an item is subject to legitimate debate within the accounting profession or possibly with respect to items for which the accounting treatment is admittedly arbitrary to begin with. A good example of the former case was the resolution of the disagreement over the accounting treatment of the investment tax credit. But, of course, distinguishing legitimate debate from concocted accounting controversies designed to advance special interests would not be easy. I would place the debate over the FASB's proposal to require expensing of compensatory stock options in the latter category.

The best example of an arbitrary accounting standard is probably financial depreciation. The benefits of allowing firms to utilize more decelerated financial depreciation methods than are permissible today would seem to outweigh the costs. But again, aspects of many standards could be deemed arbitrary, and limiting intervention to this subset of standards would be difficult.

If instrumental accounting could be limited to breaking ties in cases of legitimate accounting controversy or adjusting arbitrary standards to take the pressure off of tax incentives and direct subsidies, there could be significant social gains. I would welcome suggestions along these lines. However, without reason to think that intervention could be limited, the risks of encouraging intervention seem to outweigh the gains.

VII. Conclusion

Using financial accounting standards to help shape corporate behavior is a provocative idea, but whether instrumental accounting ultimately is embraced as a public policy tool is to some degree secondary. The main argument of this Article has been that accounting standards shape corporate behavior, whether we recognize the fact or not, and that this power of accounting has important public policy implications. We cannot adequately evaluate calls for increased book-tax conformity or other proposals with accounting implications without taking the incentive properties of accounting rules into consideration.

For what are proposals for increased book-tax conformity but calls for instrumental accounting? Proponents seek to influence corporate behavior with respect to tax sheltering and earnings inflation by adjusting the conventions of book and tax accounting. Unless one believes that Congress would accept GAAP for both, book-tax conformity inevitably involves changes in substantive financial accounting rules with all of the costs outlined in the previous Part. Moreover, proponents of increased book-tax conformity should certainly beware the rest of the camel. While increased conformity may be advantageous in isolation, we should be concerned that encouraging Congress to intervene in financial accounting in the name of conformity could start us down the road towards wholesale politicization of the standard-setting process.

This much we can surmise, even though we lack confidence in our understanding of *why* accounting has behavioral effects. However, in order to fully evaluate the social welfare implications of instrumental accounting and appreciate the nuanced effects of various book-tax conformity proposals, we need a better understanding of the extent to which accounting effects reflect an agency problem. I have argued that in cases like *Kamin* and managerial resistance to stock option expensing, agency costs likely dominate shareholder-regarding explanations, but much more evidence is needed.

Given the ever increasing complexity of corporate financial arrangements, we can expect a steady flow of new FASB statements and interpretations. Without a fuller understanding of the role of financial accounting in corporate behavior, however, even avoiding inadvertent instrumental accounting may be difficult.