Learning objectives

3.1 Understand the meaning of ‘regulation’ together with some of the various theoretical arguments for regulating the practice of financial accounting.

3.2 Understand some of the theories that explain why regulation is initially introduced.

3.3 Understand various theoretical perspectives that describe the parties who are likely to gain the greatest advantage from the implementation of accounting regulation.

3.4 Understand some of the various theoretical arguments that have been proposed in favour of reducing the extent of regulation of financial accounting.

Learning objectives (cont.)

3.5 Understand that accounting standard-setting is a very political process which seeks the views of a broad cross-section of financial statement users.

3.6 Understand the relevance to the accounting standard-setting process of potential economic and social impacts arising from accounting regulations.
Why examine theories of regulation?

- Better placed to understand why some accounting prescriptions become part of legislation while others do not
- As students of accounting we should have some insights into what political factors might have influenced the development of the various rules we learn
- Accounting standard-setting is a very political process
  - while some proposed requirements may be technically sound and logical, they may not be mandated due to political ‘power’ or influence of some affected parties

What is regulation?

- The Oxford Dictionary defines regulation in terms of a ‘prescribed rule’ or ‘authoritative direction’
- The Macquarie Dictionary defines regulation as ‘a rule of order, as for conduct, prescribed by authority; a governing direction or law’
- On the basis of these definitions we can say that regulation is designed to control or govern conduct
- Hence when we are discussing regulations relating to financial accounting we are discussing rules that have been developed by an independent authoritative body that has been given the power to govern how we are to prepare financial statements, and the actions of the authoritative body will have the effect of restricting the accounting options that would otherwise be available to an organisation

‘Free-market’ perspective

- There are alternative views on the need to regulate accounting disclosure
- One view – the free-market view – is that we do not need all the regulation we currently have
  - accounting information should be treated like other goods, with demand and supply forces allowed to operate to generate an optimal supply
Arguments supporting ‘free-market’ perspective

- Private economic-based incentives
- ‘Market for managers’
- ‘Market for corporate takeovers’
- ‘Market for lemons’

Private economic-based incentives

- Assumed that managers will operate the business for their own benefit and this will always be expected by shareholders and debtholders
  - so if managers’ self-interested behaviour is not controlled then they will be paid a lower salary
- Therefore, it is in the interests of management to enter contracts with shareholders and debtholders to constrain their actions
- Contracts often based on accounting information
  - accounting-based management bonus schemes
  - accounting-based debt covenants

Private economic-based incentives (cont.)

- Organisations not producing information will be penalised by higher costs of capital
- Organisations best placed to determine what information should be produced
  - dependent on parties involved and assets in place
- Imposing regulation restricting the available set of accounting methods decreases efficiency of contracting
- Also assumed that auditing will take place in the absence of regulation—reduces risk to external stakeholders
  - allows organisations to attract funds at lower cost
Problems in presence of many different parties

- The ‘contracting argument’ might be good in principle but tends to have problems in the presence of many owners or debt holders
  - may be too many parties for contracting to be feasible
  - prohibitive cost of negotiation if different investors want different information
  - costly to negotiate single contract with all investors as they need to agree on information provided
  - is it realistic that every party will assume every other party is driven by self-interest?

‘Market for managers’ argument

- Another argument used to counter regulation is that in the absence of regulation managers will still do the ‘right thing’ because of the ‘market for managers’
- Managers’ previous performance impacts on remuneration they can command in future
- In the absence of regulation it is assumed managers will be encouraged to adopt strategies to maximise value of firm (provides favourable view of own performance)
  - includes providing optimal amount of accounting information

Assumptions underlying ‘market for managers’ argument

- Managerial labour market operates efficiently
- Information about past performance is known by prospective employers and will be impounded in future salaries
- Capital market is efficient
- Effective managerial strategies are reflected in positive share price movements
  - however, problems arise if the manager is approaching retirement
  - also, we might question whether the managerial labour market is always efficient
'Market for corporate takeovers’ argument

- Another mechanism to motivate managers to do the ‘right thing’ even in the absence of regulation is the ‘market for corporate takeovers’
- Underperforming organisations will be taken over by another entity with the existing management team subsequently replaced
- Therefore managers are motivated to maximise firm value
- Information produced to minimise cost of capital thereby increasing firm value
  - assumes managers know marginal cost and marginal benefits of information

'Market for lemons’ argument

- Another mechanism is the ‘market for lemons’
- No information is viewed in the same light as bad information
  - market may make the assessment that silence implies the organisation has bad news to disclose
- Therefore managers are motivated to disclose both good and bad news
- Evidence that both good and bad news is disclosed voluntarily (Skinner 1994)

'Market for lemons’ argument (cont.)

- Assumes the market knows that managers have news to disclose
  - may not always be a realistic assumption – for example, consider high profile cases like Enron
- If knowledge of non-disclosure becomes available later, market expected to react at that stage
- Taken together, the various factors just discussed (market for managers, market for corporate takeovers, market for lemons, expectations about self-interest and the resulting use of contracts, and so forth) are considered to provide justification for restricting accounting regulation
  - Is this realistic? Do we really believe these mechanisms are likely to work ‘efficiently’? From whose perspective do we assess ‘efficiently’?
Pro-regulation perspective

- Accounting information is a public or ‘free’ good
- It should not be treated the same as other ‘goods’
- In the presence of free riders, true demand is understated
  - pricing system does not function properly
- Leads to underproduction of information
- Regulation necessary to reduce impacts of market failure

Should supply of ‘free’ goods be regulated?

- Some people argue that free goods are often overproduced as a result of regulation
- The public, knowing they do not have to pay, will overstate their need for the good or service
  - e.g. investment analysts
- Could lead to ‘accounting standards overload’

Role of Adam Smith’s ‘invisible hand’

- ‘Invisible hand’ notion used as argument in favour of free market
  - without regulatory involvement, as if by an invisible hand, productive resources will find their way to most productive uses
- Some (for example, Milton Friedman) went on to argue that leaving activities to the control of market mechanisms will actually protect market participants
  - the central feature of the market organisation of economic activity is that it prevents one person from interfering with another in respect of most of its activities. The consumer is protected from coercion by the seller because of the presence of other sellers with whom he can deal. The seller is protected from coercion by the consumer because of other consumers to whom he can sell.
  - Does this sound logical? What are the assumptions? Do we believe that freely operating markets will protect us?
Role of Adam Smith’s ‘invisible hand’ (cont.)

- The free-market argument ignores market failures and uneven distribution of power
- Smith was concerned where monopolistic powers were created by government intervention
- But Smith advocated regulatory intervention in some instances
  - where in the public interest to protect the more vulnerable

Why was Smith’s work misrepresented?

- It is in the interests of many businesses that regulatory interference be reduced
- The work of acclaimed economists, such as Adam Smith, used as ‘propaganda’ to support their position

Theories to explain the introduction of regulation

- There are theories available to explain what motivates politicians/regulators to introduce regulation.

- These theories include:
  - public interest theory
  - capture theory
  - economic interest group theory (private interest theory)
Public interest theory

- Regulation is put in place to benefit society as a whole rather than vested interests
- Regulatory bodies/politicians are considered to represent the interests of the society in which they operate, rather than the private interests of the regulators/politicians
- The enactment of regulation is a balancing act between the perceived social benefits and the perceived social costs of the regulation
- Assumes that government is a neutral arbiter
- Do we agree with the above assumptions?
  - Do the assumptions match with our knowledge of politicians?

Capture theory

- While regulation might be introduced with the goal of benefiting the public, this goal may not subsequently be achieved
- The regulated party or industry will seek to take charge of (capture) the regulator
- Once the regulator is ‘captured’ the industry representatives will seek to ensure that the rules subsequently released are advantageous to the parties subject to regulation
- Although regulating initially in the public interest, difficult for regulator to remain independent

Capture of accounting standard-setting

- Walker (1987) analysed capture of Australian standard-setting through the ASRB, arguing that
  - the accounting profession lobbied before the Board established to ensure no independent research capability, no academic as chair, and to receive admin officer not a research director
  - priorities only set after consultation with AARF
  - ASRB fast-tracked AARF submissions but not others
  - majority of Board membership were members of the accounting profession
Criticisms of capture theory

- No reason to suggest that regulated industry the only interest group able to influence the regulator
- No reason why regulated industries only able to capture existing agencies rather than procure the creation of an agency
- No reason why regulated industry could not prevent creation of the regulatory agency

Economic interest group theory

- The economic interest group theory of regulation assumes that groups will form to protect particular economic interests
- Groups are often in conflict with each other and will lobby government to put in place legislation which will benefit them at the expense of others
- No notion of public interest inherent in the theory
- Regulators/politicians (and all other individuals) are assumed to be motivated by self-interest

Economic interest group theory (cont.)

- The regulator is not a neutral arbiter but is seen as an interest group itself
- The regulator is motivated to ensure re-election or maintenance of its position of power
- Regulation serves the private interests of politically effective groups
- Those groups with insufficient power will not be able to effectively lobby for regulation to protect their own interests
Examples of application to accounting standard-setting

• The release of new or revised accounting standards have real economic and social consequences
  – for example, consider how the adoption of AASB 138 Intangibles might have created real economic impacts within Australia
  – or consider the new accounting standard for leasing that is being developed
• Industry groups may lobby to accept or reject a particular accounting standard
  – e.g. European Banks in relation to IASB 39
• Large politically sensitive firms found to lobby in favour of general price level accounting in US (led to reduced profits)
• Accounting firms lobbying to protect their own interests

Accounting regulation as an output of a political process

• The view that financial accounting should be objective, neutral and apolitical can be challenged
• Will inevitably be political as it affects wealth distribution within society
• Standard-setters encourage affected parties to make submissions on drafts of proposed standards

Accounting regulation as an output of a political process (cont.)

• If standard-setters give consideration to views in submissions, accounting standards and therefore financial reports are the result of various social and environmental considerations
  – tied to the values, norms and expectations of the society in which standards are developed
  – questionable whether financial accounting can claim to be neutral and objective
Accounting regulation as an output of a political process (cont.)

• Compliance with accounting standards is usually seen to indicate financial statements are ‘true and fair’
  – can or should financial statements that have been prepared on the basis of accounting standards (with such standards having been developed after taking into account various economic and social consequences) be deemed to be ‘true and fair’?
• Users may not be aware that financial reports are the outcome of various political pressures
• Should regulators consider preparers’ views given that standards are designed to limit what preparers do?