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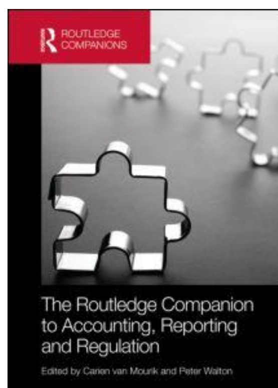

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Carien van Mourik, Peter Walton

Perspectives on the Role of and Need for Accounting Regulation

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Lisa Baudot
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Perspectives on the Role of and Need for Accounting Regulation

Lisa Baudot

1. Introduction

This chapter examines different perspectives on the role of and need for the regulation of accounting information. Accounting information is distinguished in this chapter as information on the economic activities of the firm including information presented on the face of the financial statements as well as information disclosed in the footnotes to the financial statements or through other means of disclosure. This information can serve the role of communicating with both public and private sources, where 'public' in this sense refers to the debt and equity (capital) markets and 'private' refers to other, non-market providers of financing. The perspectives presented in this chapter focus primarily on regulation in jurisdictions in which the primary role of accounting information is its usefulness to shareholders in making investment decisions in the capital markets. However, the primary role of accounting information in many economies has been on information useful to other stakeholders and for purposes outside of capital market decision-making (i.e. stewardship, debt contracting, etc). The chapter also addresses the perspectives on such non-market roles of accounting information albeit to a lesser extent as globalization has in a large way shifted the focus of accounting information worldwide such that the capital market role of accounting information has become more and more relevant and, to a certain extent, reduced its non-market roles.

The bulk of this chapter is organized around the arguments refuting the need for accounting regulation and the arguments confirming the need for accounting regulation. Before entering into these debates, Section 2 provides the platform for these debates in presenting a historical overview of regulatory developments in a number of environments, that of the United Kingdom, the United States, France and Germany. Section 3 then looks at the theoretical arguments refuting the need for regulating accounting information, the problematics of unregulated information and the theoretical arguments promoting regulation as solutions to these problematics. Section 4 goes on to discuss different perspectives on the nature of regulation, the beneficiaries of such regulation, and the motivations of the various regulatory structures from a socio-political perspective as well as a professional-practice perspective. Section 5 concludes.

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2. A brief history of the development of regulation[1]

Financial accounting as practice can be traced back to the thirteenth and fourteenth centuries; however, the regulation of accounting information in most economies has only developed during the past two hundred years. Despite its relative youth, the regulation of business enterprise, and the regulation of accounting information that accompanied it, is a phenomenon with deep roots. This section traces those roots through the eras of industrialization in the UK, the US, France and Germany, distinguishing the particularities of each setting and the influence of those particularities on the way in which accounting regulation developed.

2.1 Anglo-American development of regulation[2]

The eighteenth and nineteenth centuries in the UK were marked by transformation from an agricultural-based economy towards commercial and manufacturing activities. Business enterprises during this period were small, with owners directly involved in day-to-day control of operations, and financial information was largely outside the public domain. As such, accounting information served mainly as a stewardship function. However, growth in the size of business enterprises in the post-Industrial Revolution period brought about the separation of ownership and control, changing the role of accounting information dramatically. This change was necessitated in order to adapt the stewardship role of accounting information to the reporting of information to owners no longer directly involved in managing the day-to-day operations of the company.

Changes to the way in which business enterprises were formed in the UK further transformed the role of accounting information in the nineteenth century. For instance, the Joint Stock Companies Act of 1844 allowed business enterprises to be incorporated by registration.[3] Registration required the company to maintain 'books of account', to present a balance sheet but no profit and loss statement at shareholders meetings and to file such information with the Registrar of joint stock companies (Nobes and Parker, 2004). In addition, the Act required the appointment of auditors and the preparation of an audit report for the annual shareholders meetings; however, the auditing profession had not then been formally established.

While the 1844 Act intended to cultivate business and increase the public's confidence in economic institutions, the prevailing attitude of the state not to interfere in business matters was apparent and the new joint stock companies found the requirements of the Act simple enough to breach. The Joint Stock Companies Act of 1856 abandoned mandatory requirements in favour of a voluntary model containing clauses for both accounting information and the audit of that information. Further, where the 1844 Act had not addressed shareholder liability, it was followed in 1855 by the Limited Liability Act which restricted the liability of the individual owners of a business enterprise to their personal investment in the company. These changes appear to have been the result of the view that shareholders (and creditors) were free to enter into an agreement with management and that such agreements were matters of private contract.

Near the turn of the century the Company Law Amendment of 1895 brought accounting information back into the public domain with the mandatory filing of annual balance sheets with the Registrar; however, there was a general absence of guidance on filing requirements that went unresolved until the Companies Act of 1948. The 1948 Act not only reinstated the accounting and audit requirements of the 1844 Act but made those requirements much more explicit. For example, all companies were called on to file consolidated, audited financial information showing a 'true and fair view'[4] and providing many new disclosure requirements designed to preserve financial stability and encourage investor confidence in the market. Some tend to consider the requirements of the UK Companies Act of 1929/1948 as the basis for the requirements which would follow not long after in the US environment.

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Similar to the UK, the industrialization of the US economy engendered profound changes in the nature of business enterprise. In particular, the second half of the nineteenth century saw a wealthy group of industrialists, including the Carnegie steel, Rockefeller oil, and Vanderbilt railroad trusts, come to dominate fractions of the developing economy through the consolidation of their industrial holdings (Lamoreaux, 1985). The wealth of these trusts, and the economic and political power they demonstrated, prefigured even more profound trends. Those trends came in the development of a new form of economic organization – the corporation – which captured markets across sectors and regions, and the emergence of new centres of financial power to accommodate the capital requirements of these corporations (Lamoreaux, 1985).

The rise of these corporations and financial centres may be seen as inadvertently fashioning the US regulatory state because it was in response to the rise of business power that the appeal for regulation originated (Djankov *et al.,* 2003). For example, debates over the potentially abusive power of trusts and corporations are largely considered to have prompted the passage of the Sherman Act in 1890 which aimed to restrict the capacity of the new corporations to manipulate market competition (Moran, 2010). However, events of the early twentieth century reignited the tradition of suspicion of big business, and especially of big business identified with the money trusts of Wall Street. These events include the collapse of production, mass unemployment, and revelations of fraud, culminating in financial catastrophe with the stock market crash of 1929 and the subsequent economic depression (Moran, 2010). Out of this came the 'New Deal', a series of social and economic reforms which created some of the key institutions of the US regulatory state and instilled a distinctly US way of structuring the relations between business and the state (Moran, 1991). The new regulatory institutions were structured to restore public confidence in the capital market through a kind of cooperation between business and the state represented by a series of securities legislations.

First, the Securities Act of 1933 required any offer or sale of securities to be registered as opposed to governed by state laws as they had been previously. While the 1933 Act applies to the original issue of securities, the secondary trading of those securities falls under the purview of the Securities Exchange Act of 1934. The 1934 Act established the requirement for companies seeking to trade their securities to provide periodic reporting of accounting information and independent verification of that information, and also formally established the Securities and Exchange Commission (SEC) as the federal agency responsible for regulating the securities markets. The primary function of the SEC is to ensure that issuers fully disclose all accounting information that a reasonable shareholder would require in making investment decisions. As such, the Acts aim to protect capital market investors not only by ensuring the availability of accurate and complete accounting information but also through establishing penalties for noncompliance with the Acts.

In contrast to the focus on the control of private business enterprises in the UK and the protection of capital market investors in the US, creditor protection has been at the crux of French and German financial regulation for several centuries. Zysman (1983) distinguished the French system as credit-based governmental compared to the German system of credit-based financial institutions. The historical development of the role of accounting information in these two systems is highlighted within this section.

2.2 Continental European development of regulation[5]

From the eighteenth-century French Revolution, business tradition recognized private property as the key organizing principle of economic activity. Therefore, the establishment of property

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rights laws that supported the existence of small agricultural holdings, small family-owned businesses and the defence of private wealth represents an early influence on the role of accounting information in France. In this environment, a form of accounting emerged which placed primary emphasis on the balance sheet as opposed to income or cash flows with a focus on debt, solvency, liquidity and capital maintenance (Nioche and Pesqueux, 1997). The primacy of this role of accounting information was also reflected in how French public companies took shape during the Industrial Revolution in the early nineteenth century.

The Industrial Revolution in France was spearheaded by a small number of entrepreneurs who addressed the considerable financial and management resources necessitated by the growing industrial environment through partnership formation (Nioche and Pesqueux, 1997). Partnerships therefore became the dominant business structure with a smaller number of business enterprises, which were either directly or indirectly state run, seeking financing through incorporation as joint-stock companies. The right to incorporation was consolidated within Napoleon's 'Code de Commerce' ('Commercial Code') of 1807. While French companies were previously created by a special act of the French state, the 'Code' allowed joint-stock companies to be formed according to general company laws though the state's permission was still required. In addition, the 'Code' recognized limited liability for members of the joint stock company. Ultimately, the 'Code' came to serve as a model for later European statutes, including the one in Germany discussed in this section.

Through the Companies Act of 1856, financial accounting requirements in France, as elsewhere, grew out of the desire for limited liability companies to publish their accounts. However, these requirements were created in consideration of the particularities of the structure of business as largely controlled by the state. Other influences on the role of accounting information in the French credit-based governmental system included the introduction of income taxes in 1920 and a doctrine of fiscal administration. Finally, the role of accounting information in the French system is influenced by the French 'Plan Comptable Général' ('PCG' - General Chart of Accounts) of 1947. The objective of the 'PCG' was to facilitate better government decision making and therefore maintained the focus on debt and solvency issues as opposed to profitability (Nioche and Pesqueux, 1997). However, all business forms are covered by the 'PCG' and follow the same accounting procedures and formats despite having objectives which may vary from national fiscal and economic policy.

Corporate ownership remained in the hands of the state and families through the late 1980s and early 1990s when a significant number of corporations owned by the state went public lessening the direct influence of the government on the economy. Up until this period of deregulation, nationalized financial institutions had been an important tool in providing financing for firms and supporting critical industries. The relationship between the banks and the public companies were regulated by contracts designed to ensure that the future actions of the firm comply with solvency and liquidity covenants thereby limiting dividends to shareholders and highlighting the role of accounting information in this environment in private contracting.

Similarly, the German business environment is characterized by large holdings by financial institutions that not only provide loans to companies but also control major proportions of firms' equity capital (Leuz and Wustemann, 2004). Here, the creditor protection principle emphasizing the need to protect creditors against losses is so fundamental to German accounting that dividend restriction is built directly into accounting rules. The German focus on creditor protection was established with the introduction of early German law such as the 'Preußisches Allgemeines Landrecht' ('ALR' – Prussian Civil Code) of 1794. The 'ALR' required business enterprises to maintain orderly records of their transactions and was intended to reinforce growing

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creditor involvement in trade activities and serve as evidence which could be used in the protection of creditors in court proceedings (Eierle, 2005).

Creditor protection gained additional importance in the German financial reporting model through nineteenth-century enactments such as the 'Allgemeines Deutsches Handelsgesetzbuch' ('ADHGB' – General German Commercial Code) of 1861. This was superseded by the 'Handelsgesetzbuch' ('HGB' - German Commercial Code) of 1897 which remains the basis for accounting in Germany today. The 'ADHGB' was strongly influenced by the French Code whose measures had emerged within an environment of state control over business (Eierle, 2005). As such, debates arose about the appropriateness of the 'ADHGB' when applied within the German economy and in 1897 the legislators enacted the 'HGB'. The 'HGB' further adapted the 'ADHGB' towards the principle of prudence (i.e. historical cost approach and conservatism) in acknowledging the extensive participation of government and banks in business transactions (Eierle, 2005).

The importance of creditor protection is also revealed through a number of other enactments. For example, the role of accounting information in Germany is also influenced by income tax law which dictates that the (prudence) principles of the 'HGB' shall be applied in determining the tax accounts. Further, the enactment of Public Company Law of 1884, which occurred in reaction to a significant loss of investor funds after the collapse of a number of important corporations during the late 1800s, led to rules for restricting excessive capital distribution (Eierle, 2005). Likewise, economic crisis in Germany during the early 1900s led to the enactment of the Stock Corporation Emergency Decree of 1931 and to the Stock Corporation Law of 1937. These enactments specified extensive modifications with regard to financial reporting in annual financial statements, yet maintained the traditional principles of creditor protection given the continued financing role of financial institutions and the state.

3. Accounting regulatory debates: economic burden or necessary evil?

As indicated in the previous section, the regulation of accounting information is a fairly recent phenomenon which developed with the role of accounting information in different environments. In the Anglo-environment, the regulation of accounting information developed alongside the role of accounting information in the public debt and equity (capital) markets. On the other hand, while the capital markets have played a more recent role in the regulation of accounting information in the EU, the early primacy of other sources of financing, i.e. government and financial institutions, translated to a greater role for accounting information provided to non-market actors. This section presents the competing schools of thought on the need for regulation in consideration of these varied roles for accounting information.

3.1 Considerations refuting the need for regulation

> There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.
>
> *Milton Friedman, Economist*

The fundamental argument against regulation (i.e. for reducing or eliminating regulation) proposes that accounting information should be treated like any other economic good and that forces of demand and supply, as opposed to regulatory forces, should be allowed to determine the optimal amount of information to be produced (Buchanan, 1968). In the 'market'

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for accounting information, financial statement users represent the demanders of information while managers/firms act as the suppliers. The quantity of accounting information produced will then be a function of the amount of information that financial statement users demand and managers/firms supply (Sunder, 2002). As the primary users are linked to the role of accounting information in a given economy, users of information in environments where financing is raised in the public markets will demand different types of information and in different ways than users of information in environments where financing is obtained through non-market sources.

For example, in a system based on sources of capital obtained from the public debt or equity markets, users of accounting information who are ultimately potential investor-owners will reside largely outside of the firm where they do not have access to the same level of information as managers of the firm (Ball *et al.,* 2000). This raises the possibility of what is referred to as 'information asymmetry' in that the managers, as firm insiders, know more than the investors, as firm outsiders, about the true state of a firm's performance (Stigler, 1961). Argumentation, based on the work of Arrow (1963), Akerlof (1970), Jensen and Meckling (1976) and Watts and Zimmerman (1978), shows how private incentives encourage a firm and its management to voluntarily provide full and credible information to outsiders, reducing the information asymmetry issue, and negating the need for regulatory action.

The capital market-based system can be contrasted with the system in which a firm relies more on financing from non-market sources. In the second type of system, firm insiders establish close relationships through contracts with banks and other financial intermediaries (Leuz, 2010) and the focus of accounting information facilitates the protection of these contractual arrangements by limiting the claims of firm outsiders to dividends and external payments (Leuz and Wustemann, 2004). Here, the need for regulation is refuted in that private channels of communication keep key contracting parties reasonably well informed. However, the traditionally low focus on public dissemination of information in this system means that, as capital markets grow, investors face a potential lack of transparency in not having access to these private communications, bringing us back to the problem of information asymmetry (Ball *et al.,* 2000). The information asymmetry-based arguments refuting the need for regulation involves a presentation of the notions of adverse selection and moral hazard as well as a consideration of the role of governance factors. These notions are introduced in the following sections.

3.1.1 Adverse selection

Adverse selection refers to a situation of asymmetric information presented by firms which results in the highest quality firms being squeezed out because they are unable to distinguish themselves as high-quality to potential investors. The theory, developed in the 1970s by George Akerlof, was based on a study of the used car market (i.e. the market for 'lemons'[6]). Akerlof's study determined that buyers might be willing to pay for high-quality used cars; however, it is difficult for them to distinguish high-quality cars from low-quality cars given that the sellers of the cars do not have an incentive to be completely honest. Thus, asymmetric information between buyers and sellers regarding true quality causes the buyers, fearing to get a 'lemon', to offer only a lemon price. On the other hand, the sellers offer only lemons for sale, so the high-quality used cars are 'driven' out of the market.

Adverse selection translates to the accounting environment in terms of the information exchange between market participants where buyers (i.e. outsiders = investors/creditors) have access to less information than sellers (i.e. insiders = firms/managers). As the outsiders do not have the same level of information as the insiders, they are hesitant to invest, doubting that they

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can make good investment decisions on the basis of limited or potentially biased information (Kothari *et al.,* 2010). Firms will be encouraged to provide sufficient and credible information to the market, even if that information represents 'bad news', in order to avoid being punished for the absence of information (Grossman, 1981; Kothari *et al.,* 2010).

Punishment can potentially affect the liquidity of the firms' stocks and occurs through shareholders reducing the amount they will pay for shares and securities analysts or investment managers penalizing firms through negative reputational information (Bushman and Landsman, 2010). Therefore, firms and managers have an incentive to voluntarily supply accounting information in order to reduce information asymmetry and avoid punishment. Firms can reduce information asymmetry even further by ensuring the accounting information that they supply to the market is credible and are presumed to do so by subjecting such information to voluntary certifications by independent auditors (Fama and Jensen, 1983). Finally, as discussed in the section on pro-regulatory arguments, financial reporting and disclosure regulation itself is another possible factor reducing adverse selection issues.

3.1.2 Moral hazard

Moral hazard involves information asymmetry in a contracting situation in which one party has more information than the other. The party that has more information, feeling protected from risk or at least from the consequences of their actions, has the tendency to perform at a less than desirable level, leaving the second party to hold the risk/responsibility for the first party's actions. The party with more information has no incentive to consider the full costs of their behaviour to the other party due to the protection they perceive under the contract and the fact that their behaviour cannot be fully observed by the other party.

Moral hazard translates to the accounting environment through the information exchange between contracting parties who maintain ownership (or accept financing risk) of firms versus parties who maintain management control. The relationship between such parties has been characterized in the literature by Jensen and Meckling (1976) as a principal–agent relation (i.e. agency theory[7]). Under this theory, conflict between ownership (financing risk) and management control functions results because the agents (managers) who control the firm's operating activities clearly have more information about their own actions and intentions than the principals (shareholders or creditors). In the absence of information, the shareholders or creditors of the firm will assume that managers may be operating the business with the goal of maximizing their personal wealth rather than with the aim of maximizing firm value or meeting the requirements of contractual debt covenants (Kothari *et al.,* 2010).

The focus is then on designing manager incentives in such a way that, even under conditions of asymmetric information, the manager's goals of wealth maximization can be more closely aligned with shareholders' (creditors) presumed goals (Watts and Zimmerman, 1986). Addressing the moral hazard problem involves measuring and presenting financial information in a way that accomplishes contracting goals through management performance. This implies constraining managers through contractual commitments so that certain strategies against the interests of shareholders and creditors will not be undertaken. For example, management contracts with shareholders may require the managers' performance to be tied to profits; contracts with bond holders may require profits to cover interest expense by a number of times; and contracts with financial institutions may require adhering to certain solvency and liquidity ratios.

What is clear is that contract terms are often tied to accounting information and here the perspective refuting the need for regulation deems the contracting parties to be in the best

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position to determine both the terms and the information that should be produced (Leuz, 2010) to satisfy and resolve potential moral hazard issues. Under this view, regulation is seen as restricting the set of accounting methods available for producing information and implies that some managers will be prohibited from using the accounting methods which they believe best reflect their particular performance and position relative to their contractual obligations (Leuz and Wustermann, 2004). However, the methods which managers believe best reflect their particular performance and position may also be the most opportunistic methods; those bringing the most personal wealth to the manager and potentially shifting wealth from the shareholders.

3.1.3 Governance factors

Where contracting may not provide absolute control over managerial opportunism, monitoring through governance by internal and/or external actors plays a role to further constrain such opportunism. Fama and Jensen (1983) identified several governance solutions to resolve contracting issues, including:

- accounting information being subject to verification by independent auditors;
- the market for corporate control; and
- the related market for the hiring/firing of managers.

Relative to the first governance solution, verification of financial information by an independent party is deemed to increase the reliability of accounting information and decrease the information asymmetry perceived by outsiders (Watts and Zimmerman, 1983). Those who favour unregulated accounting environments expect management to issue credible information for outsiders to monitor their behaviour in the market, which implies that financial statement audits could be expected to be undertaken even in the absence of regulation and some research provides evidence of this (e.g. Watts and Zimmerman, 1983).

The second set of governance solutions mentioned, the market for corporate control (hostile takeovers, mergers and acquisitions, etc.) and the market for management resources, assume that accounting information will be voluntarily produced due to perceived threats. In the first instance, the market for corporate control argument predicts that an underperforming firm will be taken over by another entity and the existing management team will be subsequently replaced. Under such threat, managers would be motivated to maximize firm value in order to minimize the likelihood that another entity could seize control of the firm. On the other hand, the market for management resources argument (Fama, 1980) assumes an efficient labour market in which managers' prior performance will impact their level of remuneration in future periods. Under the threat of not maximizing their future wealth, managers adopt strategies to provide a favourable view of their current performance by maximizing the value of the firm. However, both arguments assume that in maximizing firm value managers are able to determine the 'optimal' level of accounting information to provide.

Finally, the governance factors discussed previously apply more to environments in which the role of accounting information is to serve the needs of the capital market. In environments in which the role of accounting information is to (primarily) serve the needs of non-capital market sources of finance, such as governments and financial institutions, a different set of governance factors apply. For example, considering that financial institutions may not only play a major role in financing but also may control substantial equity stakes in a firm, these institutions are typically represented on the supervisory board of the firms they finance (Ball *et al.,* 2000).

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The supervisory board is the main instrument of governance in the German environment, for instance, and the financial institution's role on the board and stake in the firm indicates that both governance and control are in the hands of insiders (Leuz and Wustermann, 2004). In this particular setting, the regulation of accounting information is argued to be unnecessary since the primary users of information represent parties to a contract who agree contractually to the accounting information to be privately communicated by the firm (Ball *et al.,* 2000).

3.2 Considerations supporting the need for regulation

> Regulations may, no doubt, be considered in some respect a violation of natural liberty. But exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments; the most free as well as the most tyrannical.
>
> *Adam Smith, Political Economist*

The previous section highlighted a number of reasons refuting the need for accounting regulation. The primary reasoning given was that accounting information is similar to any other economic good and, as such, financial statement users will demand information to the extent it is useful and firms will supply the desired information. Here, it was argued that firms will voluntarily produce accounting information without regulation mandating that they do so in order to avoid any potentially negative consequences of uncertainty about the firm. The consequences of uncertainty were presented as potentially increased costs of capital to the firm or increased reputational and labour market risks to the manager.

Again, these arguments relied on the view that accounting information is an economic good, analogous to a product or service produced and consumed in a market that operates efficiently (Fama, 1970). Fama's 'efficient market hypothesis' states that markets fully reflect at all times the collective knowledge and information that is publicly available. As such, wealth maximizing investors will take new information into consideration in their investing decisions immediately upon the release of that information (Fama, 1970). Yet markets have been shown to not always operate efficiently so that the other side of the argument is that intervention in the form of regulation is necessary in order to compensate for inefficiency in the supply and demand of information (Taylor and Turley, 1986). In addition, the true nature of accounting information is such that consumers do not pay for the information being produced as they do for economic goods. Therefore, a consideration must be made for the need for regulation from the perspective that accounting information is a not an economic good but a social good and, as such, must be regulated so as to protect society from its potentially negative consequences.

3.2.1 Inefficient markets

The efficient market hypothesis has been challenged as inconsistent with the 'real world' behaviour of the market. For example, at the market level, observations of excess stock market volatility and stock market bubbles – and at the extreme financial crises and stock market crashes – all indicate that the market does not operate efficiently. At the investor level, investors may not incorporate all available information contemporaneously and investor reactions may be biased, constrained or overconfident. Finally, additional evidence of market inefficiency has been noted at the firm level based on firms that produce fraudulent or misleading information which investors are generally unable to evaluate as to its faithful representation (or reliability), due to a situation of information asymmetry.

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This situation brings us back to the arguments from Section 3.1, which assumed that firms and management are incentivized to voluntarily provide sufficient and credible information to the market. Critics of the unregulated view propose that, in the absence of regulation, firms may not voluntarily provide the information that users desire to make informed assessments about the firm. In addition, critics consider the ability to secure sufficient information about a firm as being based on power and resources and assume that parties with limited power and limited resources will be ill-informed, worse informed or not informed in a timely manner (Sutton, 1984). Similarly, in an environment in which the role of accounting information is to serve the needs of non-market actors, where firms are more likely to provide accounting information only to private contracting parties, regulation can serve to ensure that outside parties also have access to private information (Leuz, 2010).

Such imbalances are considered to affect the overall social welfare, in that redistributions of wealth will occur on the basis of unequal access to information linked to uneven power and resources. Therefore, regulation protects investors from the information asymmetry resulting from unequal access to information (adverse selection) and uneven distributions of power (moral hazard) given the modern-day configuration of the firm. This argument for regulation can be thought of as a 'level playing field' argument that promotes equal access to the same information by all parties. On a level playing field, parties are presumed to have greater confidence that transfers of wealth are not occurring unfairly due to one party having access to more or different information which others do not have access to.

In addition to the question of equal access, there is the question of whether users of accounting information are capable of evaluating the credibility of the information they are presented with and the role that external audit plays in helping them to do so. The role of external audit, as indicated by Jensen and Meckling (1976), is one of reducing information asymmetry and increasing reliability through the monitoring and verification of a firm's financial reporting. In an unregulated environment, firms are presumed to not only present the desired level of accounting information but also to voluntarily submit that information to external verification. One only needs to consider the accounting scandals of the 1990s and early 2000s (i.e. Parmalat, Enron, Worldcom, etc.) and the ambiguous role that external audit and verification played in those scandals to question the validity of this argument.

Even with a high quality of external verification, the regulatory view sees regulation as necessary to manage the complexity of the market by setting the minimum requirements of reporting as well as the bounds within which that reporting must be prepared and presented, thereby minimizing the number of methods used, reducing the risk of 'creative' accounting, improving the level of transparency in reporting information, and increasing the amount of uniformity in accounting treatment. A similar argument may be made for regulation of accounting information which serves the needs of non-market actors in that regulation may help reduce transaction costs through a common set of rules for all or many contracts, rather than negotiating a particular set of rules on a contract-by-contract basis (Ball *et al.,* 2000). At the same time, Bromwich (1985) noted that, despite regulatory controls, firms continued to hold considerable discretion as to accounting practices and choices were often permitted in the method of dealing with given accounting items, which serves to refute the view that imposing regulation impacts firms' reporting efficiency. In summary, under the regulatory view, financial reporting and disclosure regulation is well thought to aid in ensuring that information asymmetry is reduced and to act as a mechanism by which misleading information is minimized.

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3.2.2 Public goods

Under the regulatory view, accounting information is argued to have the characteristics of a social (or public) good (Olson, 1965).[8] This means that once accounting information is available, consumers (i.e. prospective shareholders) can use and share the information freely without incurring any associated costs of production for their use (Barth, 2006; Kothari *et al.,* 2010). As such, few users will have incentive to pay for accounting information as they know they themselves can act as 'free-riders' (Olson, 1965). The effect is that, in the presence of free-riders, demand is understated because users obtain accounting information at no cost. In turn, firms will under-produce information, given their own lack of incentive to produce above what users demand. In this sense the market mechanism fails due to the inability of market forces to produce the socially acceptable amount of information. Here, regulation is argued as necessary to reduce the impacts of market failure, in other words regulation is put forth as a mechanism for alleviating the underproduction of information by mandating the minimum requirements for information that firms might not otherwise provide (Barth, 2006; Kothari *et al.,* 2010).

As a public good, both the economic and social impacts of accounting information must be taken into consideration in the regulatory process. Such a view requires an extension from the view of investors and creditors as the primary users of accounting information to a view that encompasses other users. For example, other users can refer to a company's suppliers who seek information on whether amounts owed will be repaid when due, customers seeking information on probability of continued supply of products, parts and after sales service, or union and employee groups who desire information on the stability and distribution of wealth by the company. Users can also refer to the company's competitors interested in information on the relative strengths and weaknesses of the company for comparative and benchmarking purposes as well as social responsibility groups who monitor information on the use of the environment and natural resources, safety, protection and respect for human resources. Finally, users can refer to government agencies themselves interested in information on company profitability and operations for income tax purposes or information on payroll and benefits which affect state retirement/pension and medical systems. Such a complex societal web of users with their own demands for and uses of accounting information is indicative of the challenge regulatory bodies would seem to have in establishing accounting regulations socially acceptable to all users.

4. Considering the nature of accounting regulation: theory and practice

Once regulation is introduced there are various considerations to be made in terms of the nature of regulation, those responsible for developing regulation and their motivations, and the ultimate beneficiaries of such regulation. These considerations can be categorized as theoretical considerations and practical considerations. Each will be discussed in the following sections in terms of the relevant theories and practical matters put forth to explain accounting regulation.

4.1 Theoretical considerations

> We cannot expect that any public authority will attain, or will even whole-heartedly seek, the ideal. Such authorities are liable alike to ignorance, to sectional pressure and to personal corruption by private interest. A loud-voiced part of their constituents, if organized for votes, may easily outweigh the whole.
>
> *A.C. Pigou, Welfare Economist*

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In this section, the theoretical perspectives shaping the nature of, motivation for and beneficiaries to regulation are presented and contrasted. These perspectives include both public interest theories and private interest theories. Public interest theory and its counterpart regulatory capture theory promote regulation as being (at least initially) designed to protect the public interest and are presented first. Later, the economic theory of regulation is discussed which explains how the design of regulation can be affected by, and come to serve, private interests.

4.1.1 Public interest theory

Advocates of the public interest theory (Pigou, 1932) of regulation see its purpose as achieving certain publicly desired results which, if left to the market, would not be obtained. The public interest theory of regulation proposes that regulation, supplied in response to public demand for the correction of inefficient or inequitable market practices, is designed to protect and benefit society as a whole rather than certain vested interests (Posner, 1974). As an example, new regulation is often established in response to high profile accounting failures where it is argued that such regulation will help prevent a repeat of the accounting failure and protect members of the public who have suffered a financial loss as a result of such failure. This can be seen with the enactment of the Securities Acts of 1933 and 1934 as well as with the enactment of stricter corporate governance regulations being imposed in many countries following the accounting failure at Enron, Worldcom, Parmalat and others in the early 2000s.

Under this theory, the regulatory body is presumed a neutral intermediary representing the public interest, one which allows neither its own self-interest to impact on the rule-making processes nor the self-interest of particular individuals/groups subject to regulation. As put by Scott (2003), the public interest regulator 'does its best to regulate so as to maximize social welfare. Consequently, regulation is thought of as a trade-off between the costs of regulation and its social benefits in the form of improved market efficiency'. As such, regulation represents the mechanism by which the public obtains confidence that capital markets efficiently allocate resources towards productive use. Public interest theory was the dominant view of regulation into the 1960s and still retains many adherents. However, determining what is 'in the public interest' is a normative question and the basis for objectively answering this question and then executing their objective function is often at issue (Kothari *et al.,* 2010). As such, additional questions surrounding the public interest approach include those directed at the regulators themselves. These questions include whether it is reasonable to assume that regulators fulfil their responsibilities in a disinterested manner and whether it is realistic to expect that the interests of various affected parties will not impact regulatory outcomes. In considering these questions, the public interest approach is revealed to underestimate the effects of economic and political influences on regulation. Such effects are highlighted by two alternative theories in the following sections.

4.1.2 Regulatory capture theory

Similar to the public interest theory of regulation, regulatory capture theory (Bernstein, 1955) argues that regulatory bodies and the regulations they enact are initially established to protect the public interest, often in response to systemic failures. However, in distinguishing itself from public interest theory, regulatory capture theory relaxes the assumption that regulators are neutral and predicts that regulatory mechanisms are ultimately controlled by the regulated parties (Bernstein, 1955).

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Bernstein (1955) presented regulatory capture as the natural consequence of the regulatory 'life cycle'. His life-cycle-based theory denotes the regulatory process as commencing in response to a call to protect the public from some undesirable activity. The regulatory life-cycle then takes the regulatory body from a high-profile, but inexperienced, position where regulators zealously install regulation in the public interest to a lower-profile, but more experienced position (Bernstein, 1955). During the transition from one position to another, the public is deemed to become apathetic to the initial objectives of the regulation while the private interests remain. As a result, the regulatory body becomes more inclined to defer its attention from public to private interests. Thus, the regulated parties tend to 'capture' the regulators such that the original purposes of the regulatory programme are displaced by the efforts of the regulated parties (Kothari *et al.,* 2010). A third view extends from regulatory capture theory to presume that the 'captures' will ultimately seek to ensure regulation is advantageous to themselves.

4.1.3 Economics of regulation theory

In contrast to Bernstein, Stigler (1971) posited that regulators are made up of individuals who are self-interested and those individuals will introduce regulations which are more likely to securing their continuity as individual regulators and legitimacy as a regulatory body through political support (Kothari *et al.,* 2010). Stigler's argument identifies the tendency for regulators to acknowledge their continuity and legitimacy as dependent on satisfying the expectations of those being regulated which ultimately means taking those actions in the interest of the individuals who have enough voting and monetary power to influence regulatory decisions. Further, his overall assertion was that regulation is supplied by politicians and regulators in response to the demand for regulation by various interest groups. These various interest groups compete against each other in the regulatory arena to achieve objectives that increase their income and wealth. That is, interest groups vie to shape regulatory initiatives in a way that serves their own interests. The tendency is then a shift in protection from society as a whole to the interest of particular self-interested groups within society.

As a student of Stigler, Peltzman's (1976) refined the supply- side of Stigler's demand-side analysis. Peltzman (1976) put forth that those interest groups concerned for a particular regulation are considered more likely to influence the regulators towards implementing their preferred outcome by forming into large, organized groups with strong cohesive power (i.e. lobbying). Here, regulation is viewed as the product of relationships between different groups and the regulator as well as relationships between different groups of individuals. Therefore, advocates for the economic theory of regulation believe regulation is less about the public interest than about competition for power between different interest groups, who in turn have the power to influence outcomes (Bushman and Landsman, 2010). Consequently, private interests are served.

The theories in this section highlight the political aspect of accounting regulation and this aspect is expanded upon in the next section. The history of accounting regulatory activity contains many examples of lobbying by interested parties and such behaviour has come to be recognized as inevitable in the regulatory process, despite the seemingly technical nature of accounting (Solomons, 1978). The lobbying behaviour of powerful interest groups may significantly influence accounting regulation with undue emphasis placed on the preferences of certain powerful groups to the detriment of others. In particular, the preferences of two

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powerful groups, governmental actors and professional accountants, have been denoted as potentially influencing accounting regulation. Considerations relative to the role of these two groups in the development of accounting regulation are highlighted in the last section of this chapter.

4.2 Practical considerations

As a general phenomenon, the regulation of accounting information refers to the hierarchy of rules (or standards) mandated by regulatory bodies guiding the preparation, content and form of accounting information communicated either to public or private users. The regulation of accounting information can be the product of either public or private undertakings set by a public entity, such as a government or administrative body, or by private body in the form of an association of organizations, a panel of expert individuals, etc. Regardless of the nature of the regulatory entity, its primary activities involve the development, coordination, promulgation, interpretation, and revision of accounting standards which establish a uniform approach to some potential or actual problematic of accounting information. The following section provides some historical perspective on different models of accounting standard-setting, the trend towards private standard-setting models and related concerns with this model.

4.2.1 Public regulatory models[9]

As highlighted in Section 2, the state has played a major role in the development of both French and German accounting regulation. However, under the impact of external factors such as the harmonization programme of the European Union and the increasingly global capital markets dominated by Anglo-oriented countries, accounting regulation in France and Germany has evolved to a dual system that distinguishes between the regulation of accounting information provided by consolidated groups listed on public markets and the regulation of accounting information provided by business enterprises.

In the French system, a body of legal rules relating to accounting information has emerged from a variety of sources including: EU directives implemented by national legislation; laws, decrees and orders of the French state (such as the 'Code' and the 'PCG'); and mixed public/private sources such as the 'Conseil National de la Comptabilité' ('CNC' – national accounting council) and the 'Comité de la Réglementation Comptable' ('CRC' – accounting regulation committee). Where the Code provides a framework of general accounting rules applicable to all businesses, the PCG, or national accounting plan, is the most distinctive part of French accounting regulation which represents a very detailed manual of financial accounting. The plan, first promulgated in 1947, includes definitions of accounting terms, valuation and measurement rules and model financial statements which owe as much to German as to French ideas. The plan has been revised at several points since its initial enactment, most recently to take account of EU accounting directives of the 1980s.

The PCG is administered by the CNC, originally established in 1957 and reorganized in 1996, who develops and issues opinions on accounting regulation to the CRC (also established in 1996) who has the power to enact regulation either following proposals from the CNC or through endorsement of international standards. Where the CNC is comprised significantly of accounting experts with more private than public sector membership, the CRC membership is more heavily tilted towards public sector representatives in that it is chaired by the Minister of Economy and Finance and includes the Justice Minister, the Budget Minister and judges from

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public and private law, as well as representatives of the stock exchange, professional bodies, trade unions and business enterprise. However, outside of its seat on the CNC, the French financial markets authority ('AMF' – 'Autorité des Marchés Financiers') does not have a responsibility for the development of accounting regulation. Further, as professional accountancy developed much later in France than in the UK or the US, the French professional accounting bodies have never been responsible for setting accounting standards.

In the German system, similar to the French system, the sources of authoritative regulation of accounting information also include the EU directives and commercial and tax laws of the German state; however, in Germany, authorities such as the German stock exchange and trade unions are of minor importance to accounting while accounting practice and the accounting profession play important roles. The influence of the German institute is mainly through practice recommendations as well as by consultation in the law making process. As with the French Code, the German HGB consolidates all general accounting rules for all business entities into one single source. According to the HGB, every form of business must prepare annual financial statements in accordance with the 'Grundsätze ordnungsgemäßer Buchführung' (principles of orderly accounting) established by accounting practice over time. While the principles of orderly accounting are to a certain extent codified in the HGB, this is not formal and the system functions more on the interpretation of the principles set out in the HGB as well as in public and private company law, tax legislation, and statements from the German institute of accounting professionals and academics.

As a result, there is currently no exact equivalent to 'accounting standards' in Germany. In response to criticism, the Accounting Standards Committee of Germany (ASCG) was created in 1998 and recognized for the first time that a private organization was responsible for developing accounting standards for consolidated financial reporting, consulting on accounting legislation being developed by public bodies, and representing German interest in the development of international accounting standards. However, similar to the CNC/CRC relationship in the French regulatory environment, ASCG-developed standards are only opinions or recommendations which need to be enacted by the German Ministry of Justice and therefore face possible rejection by decisions of the court. Such public models of accounting regulation stand in stark contrast to Anglo-American models of regulation by professional models presented in the next section.

4.2.2 Professional regulatory models[10]

Up until the twentieth century in the Anglo-environment there was a general absence of regulation concerning how and what information companies were required to present. This meant that practitioners used those rules which they believed were most appropriate to the particular circumstances. As such, limited uniformity between the accounting information presented created problems of comparability in the public (i.e. market) domain. Around the 1920s, researchers undertook to understand practice and identify commonly employed and accepted accounting conventions. Early researchers providing detailed descriptions of accounting conventions in existence at the time include Paton (1973), Sanders *et al.* (1959), and Paton and Littleton (1940). These studies outlined concepts such as materiality and consistency as well as the doctrines of conservatism and the matching principle. However, such studies, by simply describing current practice, did little to critically examine those practices or suggest improvements/best practices which would reduce the perceived comparability gap.

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According to Zeff (1972), a 1930 US publication resulting from cooperation between the accounting profession and the stock exchange produced a list of broadly used accounting conventions which set the foundation for their eventual codification and acceptance as what we know today as generally accepted accounting principles, or GAAP. In 1938, the SEC stated that it would only accept financial statements prepared in accordance with the generally accepted principles of the accounting profession, giving a great deal of power to the profession through the American Institute of Certified Public Accountants (AICPA). While the SEC allowed the accounting profession to take an authoritative lead in developing accounting standards and thereby in determining acceptable practice, the arrangement was designed to ensure the SEC maintained control over the ultimate determination of these standards (Zeff, 1972). From 1939, an AICPA committee, the Committee on Accounting Procedure (CAP), comprised of members of the accounting profession, began issuing statements on accounting principles called Accounting Research Bulletins (ARB).

Later, in 1959, the AICPA formed the Accounting Principles Board (APB), which released pronouncements referred to as APB Opinions. Neither the ARBs nor their APB Opinions were mandatory and as a result there tended to be many departures from the rules. From July 1973, the SEC deferred the establishment of accounting standards and principles to a private organization called the Financial Accounting Standards Board (FASB),[11] thereby replacing the CAP and the APB. As a private, expert-driven standard-setting organization, the FASB operates essentially under the oversight of the SEC and has as its primary purpose the development of US GAAP in the public interest through the 'establishment and improvement of standards of financial accounting and reporting for the guidance and education of the public'.

In the UK, the Institute of Chartered Accountants in England and Wales (ICAEW), a professional body of accountants established in 1880, released a series of non-binding 'Recommendations on Accounting Principles' to its members.[12] In 1970, the ICAEW formed the Accounting Standards Steering Committee (ASSC) with the objective of 'developing definitive standards for financial reporting', adding the Irish and Scottish professional institutes as members in the same year. These standards were referred to as Statements of Standard Accounting Practice (SSAPs) and maintained the same status as 'Recommendations' issued by the ICAEW. Later, in 1976, the ASSC became the Accounting Standards Committee (ASC) which continued to produce SSAPs until 1990 when the UK government announced the establishment of the Financial Reporting Council (FRC). With the FRC, came the creation of a private organization, the Accounting Standards Board (ASB), granted responsibility to issue UK standards called Financial Reporting Standards (FRS). However, the FRC's responsibility for developing FRS was dramatically changed by the European Union's decision to adopt international accounting standards as promulgated by the International Accounting Standards Board (IASB).

In fact, the IASB was preceded by the International Accounting Standards Committee (IASC),[13] a private body of professional accounting representatives[14] responsible for the development of international accounting standards. The IASC was formed in 1973 and initially produced voluntary accounting standards intended to ensure a minimum level of quality and comparability across developed countries and to offer a substitute to developing countries who did not have standards (Camfferman and Zeff, 2007). While providing an exchange of information and enabling national standard-setters a better understanding of practice elsewhere, the IASC and the international accounting standards (IAS) that it developed lacked authority to regulate the practice of reporting accounting information (Tamm-Hallstrom, 2004). Even when the IASC was reorganized as a blended geographic- and expert-driven organization and rebranded as the IASB in 2001, its lack of regulatory authority was retained; what changed not long after

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was European regulatory policy which mandated the application and use of the IASB's International Financial Reporting Standards (IFRS) by companies publicly listed in the European Union (Botzem and Quack, 2006), including companies listed on the UK stock exchange. Thus, since 2005, European companies have been subject to a private standard-setting model highly analogous to that of the US model.

4.2.3 Trends in regulatory models

The private standard-setting model which operates in the contemporary regulatory environment is unique. The standard-setters function with the overall aim of publishing financial accounting and reporting standards; however, in some jurisdictions, they do not have authority to mandate or enforce the use of the standards they issue. Thus the design of contemporary regulatory system often distinguishes the rule-maker from the rule-enforcer (Djelic and Sahlin-Andersson, 2006). In such systems, the various enforcement bodies – nation states, governments, and stock exchange authorities choose to support or not to support the standards promulgated, to support only certain aspects of the standards, or to contest and overrule positions issued by the private standard-setter[15] and therefore in some way hold the survival and legitimacy of the rule-makers in their hands (ibid.).

At the same time, the enforcement bodies entrust the standard-setters to set accounting standards for accounting information in the 'public interest', a notion that remains largely contested in terms of its meaning, but alludes to the standard-setters' responsibility to satisfy a variety of stakeholders. Here, economic theory of regulation, which assumes that these stakeholders form groups in order to protect their particular (private) economic interests, including those of the regulators themselves, plays a role. As discussed, these interest groups, having incompatible or mutually exclusive interests and objectives, are often viewed as being in conflict with each other and as lobbying the standard-setting body to establish standards which are beneficial to them. The lobbying of private standard-setters such as the FASB and the IASB occurs through their participation in standard-setting process.

The standard-setting process begins with the formal consideration and identification of what constitutes an accounting problematic that necessitates a standard, a stage which is referred to as agenda setting. The addition of a problematic to the standard-setting agenda is a pre-condition for the subsequent development of new (or amended) accounting standards. Once added to the agenda, the development of a standard to resolve the accounting problem identified indicates entry into the actual standard-setting stage. As mentioned, standard-setters are responsible for establishing accounting standards; however, the resolution of accounting problems requires some level of acceptance of the solution by the affected stakeholders (Sutton, 1984). This acceptance does not imply that stakeholders actually determine accounting standards, but only that they are granted the opportunity to express their views on the accounting standards they will eventually adhere to (Zeff, 2002) through the due process of standard-setting.

Due process generally refers to the means by which ethical constraints are placed on decision-making authorities, where the means are represented by a set of procedures and safeguards ensuring that authoritative bodies do not abuse their power (Richardson and Eberlein, 2011). In the accounting standard-setting environment, the particular procedures and safeguards of the standard-setting due process model include a series of activities which are open to public participation or observation, as well as established protocols for the standard-setters in conducting those activities. These protocols require the standard-setters to consider, represent and deliberate the views expressed by affected stakeholders and interest groups, balanced with their own

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particular views, so one can see how the influence of a particularly powerful interest group might come into play in this process. For this reason, due process procedures and safeguards are embedded in governance structures designed around the concepts of independence and accountability; even so, the independence and accountability of the private standard-setters has been questioned given the difficulties in designing structures that are completely neutral and free from stakeholder influence (Richardson and Eberlein, 2011).

5. Conclusion

The chapter opened with a historical presentation of regulatory developments in comparative economies and the role of accounting information in those economies. In response to the growth of business enterprises and the separation of ownership and management control as well as to financial abuse and shocks which arose in the form of accounting scandals and related business and market failures, the business environment has gradually incorporated regulation. However, the way in which regulation has been incorporated has varied depending on the primary users of and role for accounting information in a given environment. This discussion served as a contextual platform for meeting the primary purpose of this chapter in elaborating the arguments denying and affirming a need for the regulation of accounting information. Arguments opposing the need for regulation centre on the concept of the 'market' for accounting information as a self-regulating, efficiently operating mechanism while arguments supporting the need for regulation propose it as a tool for correcting the inefficiencies of the market for accounting information. These arguments have been presented in light of two critical problematics, adverse selection and moral hazard, and relative to other important governance and public policy-related factors. Finally, the chapter explored various theoretical and practical perspectives on the nature of regulation, the motivations of the regulator and the beneficiaries of regulation. In doing so, the economic, social and political factors were identified as associated with the development of accounting regulation and events were examined that shaped the evolution of the accounting regulatory system as we know it today.

Notes

1 This section provides a flavour of how the role of financial information developed in different economies and is not at all exhaustive or complete. For further reading on the details of the evolution of financial information in all major economies see Previts *et al.* (2011), and Nobes and Parker (2004).

2 This section is based on the work of Napier (2010) and Moehrle and Reynolds-Moehrle (2011) in their work on the history of accounting and reporting in the United Kingdom and the United States, respectively (both contained in different volumes of Previts *et al.*), as well as the contributors to the Nobes and Parker (2004) work on comparative studies of international accounting.

3 Joint stock companies refer to entities involving two or more individuals ('shareholders') having ownership through shares of stock issued by the company. Shares are issued in return for contributions of capital and the shareholders are free to transfer their ownership at their discretion by selling their shares to other individuals.

4 The true and fair concept, as referred to in this chapter, can be understood as the recognition, measurement, presentation and disclosure of financial information in a way that reflects economic reality, or in other words a full and accurate depiction of the activities of a business enterprise.

5 This section is based on the work of Ballweiser (2010) and Bocqueraz (2010) in their work on the history of accounting and reporting in Germany and France, respectively (both contained in the volumes of Previts *et al.,* 2011), as well as the contributors to the Nobes and Parker (2004) work on comparative studies of international accounting.

6 Lemon laws refer to US state laws that provide a remedy for car buyers in order to compensate for cars that fail to meet standards of quality and performance. Such vehicles are called 'lemons'.

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7 Note that under agency theory, owners (shareholders), as principals of the firm, are assumed to have no management control role, and managers, as agents, are assumed to have no ownership.
8 A public good refers to a good which is not necessarily destroyed or altered by individual consumption.
9 See note 5.
10 See note 2.
11 For specifics on the relationship between the US SEC and the FASB, see Zeff (2010).
12 This paragraph is largely based on Willmott (1986) and his work studying the development of the major accounting bodies in the UK.
13 Camfferman and Zeff (2007) provide an extensive history of the IASC.
14 The constitution of the IASC was signed by representatives of national professional accounting bodies from nine countries: Australia, Canada, France, West Germany, Japan, Mexico, the Netherlands, the UK and the US.
15 Whether the enforcement body has the authority to contest and overrule, endorse fully or with carve-outs or otherwise depends on the formal relationship between the rule-maker and the enforcement body.

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