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Regulation as Accounting Theory

Michael Gaffikin

Theories of regulation are discussed and compared. Some important issues relating to regulation as a substitute for research in creating theory as discussed.

Over the years there have been many arguments and debates over the necessity for regulation. Those who believe in the efficacy of markets argue that regulation is not necessary as market forces will operate to best serve society and optimise the allocation of resources. However, there are many who point out that markets do not always operate in the best interests of societies so some form of intervention in the form of regulation is necessary. This is obvious in many aspects of society. For example, if there were no road rules for drivers chaos would result on the roads. If there were no restrictions on some "economic" activities then there would not be any need of drug smugglers as the market would indicate the need (demand) for drugs which would subsequently be supplied. These are obviously extreme examples but it is not hard to realise that there are many instances were regulations protect societies from undesirable activities.

In 19^{th} century Britain there was considerable optimism over the benefits brought by the Industrial Revolution and it was deemed undesirable for governments to "interfere" with the operation of "pure capitalism". Governments, therefore, pursued a policy of what was known as laissez-faire (from the French "let be", or leave alone). However, people soon came to realise that this created many social ills and some of these are reflected in the novels of Charles Dickens, such as *Oliver Twist*, and the writings and work of other artists and social commentators. Working conditions were often dangerous and inhumane, such as making use of child labour and extraordinarily long working hours which led to considerable poverty and misery. Governments soon intervened and imposed the regulations on economic activity that were considered socially desirable.

The issue of the regulation of accounting also became an issue, especially after the economic crash of the 1920-30s which, amongst other things, led to the search for accounting principles and theory described. A major objective of accounting is to provide information to interested parties who may not have access to complete (or the necessary) information to make economic decisions – they are at an information disadvantage so there is information asymmetry. This information asymmetry is often used to justify the need for accounting regulation. However, the regulation extends well beyond the information to the preparers of information. That is, the professional competence of those calling themselves accountants or auditors and generally believed to be the most able to provide and/or supervise the provision of financial information.

Accounting and accountants are now subject to wide range of forms of regulation. There are laws governing the operation of corporations many of which involve the disclosure of financial information. In addition, there are taxation laws and laws affecting the creation and operation of professional associations, which, in turn impose regulations on their members. Regulations, therefore, are very much part of modern everyday life. However, there is disagreement on the extent to which regulation should intervene in the "free" exchange of goods and ideas. For example, a believer in a strong form of market efficiency would contend that regulation of securities markets is unnecessary as the market is always instantly informed of all relevant information. However, most people would agree that there are few, if any, instances of strongly efficient markets so some level of regulation of the flow of information concerning the operations of securities (and other) markets is necessary.

The above discussion of regulation is, however, simplified as any debate on the extent to which government should be involved in the day to day operation of society is extremely complex and has been the subject of debate by many scholars (and others) for most of our history. Underlying regulation are theories of the state, politics and ideology. For example, we talk of liberal democracies as an ideal form of society. However, liberalism is a doctrine or ideology which emphasises the maximisation of individual liberties against the encroachment of the state. This invokes questions of the determination of just what individual freedoms mean and has implications of power – who decides what freedoms are possible.

Views of Regulation

While many would see regulation as concerning "sustained and focused control exercised by a public agency over activities valued by a community" (Selznick quoted in Baldwin and Cave, 1999, p 2), there are other viewpoints. Regulation can be seen as a specific set of commands such as those contained in the Corporations Act as to the appointment of directors of a company. It may be seen as deliberate state influence which would encompass the first viewpoint and extend well beyond it. For example, the whole body of corporations law which directs the establishment, management and winding up of companies. Or it may be viewed in even broader terms and include all forms of social control and influence. This would include not only the corporations legislative requirements but other rules and directions, such as professional accounting standards and stock exchange requirements. Regulation should not be perceived purely in "negative" terms because it also facilitates and enables activities. For example, the road rules mentioned above are designed to enable people to feel secure in driving knowing that there are rules that other drivers will (should?) follow.

Reasons for Regulation

Baldwin and Cave (1999 argue that there are a number of reasons for regulation. One of the best known form of regulation was exercised by US government over the potential growth of monopolies at the turn of the twentieth century – the anti-trust legislation (for example the Sherman and the Clayton Acts). Where monopolies exist it is considered that there has been a market failure because competition does not exist. Therefore, it can be inferred from this that regulation is associated with preserving competition. Thus, it is associated with the ideology of the efficacy of markets and competition, hallmarks of capitalism. In centrally controlled economies many "monopolies" are created (usually as some form of bureaucratic control). However, in other countries it is generally believed that it is necessary to maintain an environment conducive to competition. In Australia the Australian Competition and Consumer Commission (ACCC) is charged to ensure competitiveness and rule against anti-competitive behaviour (ensuring compliance with the Trade Practices Act, 1974). Sometimes “natural” monopolies” arise where there are economies of scale that ensure the market is served at the least cost (for example, many utilities such as water, gas or electricity suppliers) in which case regulation is designed to maintain fair trading.

Regulation is considered desirable where there are “**windfall profits**” – where through some fortuitous event a firm is able to make above “normal” profits. For example, suppliers of equipment to aid search and recovery where there has been a natural disaster (which seems to be happening more regularly these days!). Because of the urgent need – the immediate demand – suppliers may attempt to charge higher than normal prices and thus generate above normal profits. Similarly, in the past many costs that are related to certain productive activities were excluded such that the “true” cost was not recognised. These costs were defined as **externalities** because they were not included. Of particular relevance in recent times are the costs of avoiding pollution, for example, discharge into the river system the cost for which had to be borne by societies at large. In any discussion of environmental or social responsibility accounting externalities are of considerable importance.

A significant problem that was central to much of the neo-empirical and positive accounting research is the need for regulation arising from information inadequacies leading to **information asymmetries**. Such research was directed at determining the possible need for regulation in the form of accounting standards to address the problem.

Regulation is sometimes necessary to ensure that “**profit skimming**” does not occur. This is when a supplier will only supply the customers that leads to the greatest profit returns and ignore supply to others. This is the central issue in respect of the privatisation of Telecom Australia. The government has to ensure that telecommunication services continue to be provided as equally and fairly as possible to all Australians irrespective of where they live; rural or urban. This case, however, is not an isolated instance and there are many other less widely known similar cases where regulation is used to ensure continuity and availability of service on an equitable basis. Similarly where there is seen to be anti-competitive and predatory pricing regulation is used as a preventative measure and outlaws such activities. Microsoft was accused of this type of behaviour (source codes for the windows platform) in the USA and the government brought law suits to overcome it.

From the perspective of consumers there are instance of what is colloquially known as the **free rider effect**. This is the situation where some consumers benefit from a service without paying for it at the expense of other consumer who *do* pay for the service. A physical example is where a business opens next to a large public car park and therefore avoids the cost of providing car parking to potential customers. This may serve as a disincentive for the producers of the service so governments will intervene and levy a tax on the service. However, the term is often used in the context of securities markets in respect of the amount of disclosure of financial information a firm must make. If regulations insist on a high level of disclosure, it is argued, some parties will benefit from the disclosure without having to bear the cost of providing the information. A similar situation is referred to as **moral hazard** where consumers not paying for a service or product over-consume without regard to the costs being borne by others. This is a problem in the insurance industry where it is often claimed that some people make excessive claims against their policies whilst others make few or no claims. Insurance is based on the idea of pooling the costs of bearing risk such that all participants benefit so when some make excessive claims they may be benefiting more than others[1].

Regulation is also necessary in the rationalisation and coordination of economic activity so as to organise behaviour or industries in an efficient manner. An example is the marketing of many primary products through a central marketing agency, such as the wool board or the marketing of fish or meat. There is similar reasoning where some central planning is necessary. Once again this is important when considering environmental impacts of activities where some people are required to bear more costs than others. In order to have an equitable outcome regulation can be designed to balance the costs borne by different sectors. For example, preserving forests may lead to timber sectors bearing a cost of a loss of jobs or firm closures so regulation is needed to ensure a fair and equitable outcome in that such costs are borne by the broader society (which benefits from the preservation of the forests).

A not so obvious need for regulation arises in labour markets. This is a highly politically charged situation. For example, the ideology of a government may want to limit membership of unions to reduce the bargaining power of labour providers so it bans compulsory unionism. This is seen by some as directly reducing the bargaining power of workers which directly affects their wages and conditions (including their health and safety).

In some countries there are or have been shortages of some goods and services so that rationing (limits to the amount of goods or service permitted to be purchase by each consumer) has been necessary. In these situations it has been believed that regulations rather than market forces enable a more just distribution. For example, a shortage of petrol could disadvantage those furthest from its supply (say rural consumers). A purely market driven reaction by suppliers would be to minimise transport costs and sell to those nearer the production in the confidence that all of the product will be sold anyway (very similar to profit skimming). Regulation can be used to ensures that there is a fairer distribution of petrol.

The above are some reasons for the necessity of regulation. In reality there may be a combination of many of the above reasons that leads to regulation. As indicated, regulation can be negative in that it prevents or restricts some behaviour or it may be positive in that it serves to encourage or facilitate activity.

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[1] But ther is always the possibility that they are suffering more than others!

Theorising Regulation

Throughout history there have been two main approaches to regulation – the European and that of the United States of America – each based on a different philosophy (perhaps more accurately different ideologies) of the need for regulation. In the US, at least since 1887, regulation has been achieved through independent boards and/or commissions charged to monitor and enforce regulation. There is an implicit belief in the functioning of the market. Consequently, ownership is left in private hands and "is interfered with only in specific cases of market failure" (Majone, 1996. p 10).

On the other hand in Europe up until the Second World War there was a suspicion and even hostility to the idea of the market solving all problems. Consequently, public ownership was the main mode of economic regulation – industries were nationalised. The resultant public ownership of industries "was supposed to give the state the power to impose a planned structure on the economy and to protect the public interest against powerful private interests" (Majone, 1996. p 11). However, the nationalisation of industries was designed not only to eliminate political power and the economic inefficiency of private monopolies but also to stimulate economic development. However, in the last fifty years, for a variety of reasons, attitudes in Europe have shifted more to the US approach – public ownership as a mode of regulation was seen to have failed. Interestingly regulation has not always achieved its stated aims and Majone (1996, pp 17-19) has compared the two approaches and found a remarkably high level of correspondence, that is, both have "failed' in remarkably similar ways! Notwithstanding this, there have been advantages from regulation.

Initially the main advantage claimed for regulation was the protection of the public interest. This applied in both modes of regulation – statutory regulation or public ownership. Regulation was believed to protect against market failure. Markets "failed" when they were not economically efficient. The notion of efficiency was formalised by an Italian economist and sociologist, Vilfredo Pareto, after which the concept is named. **Pareto efficiency** (sometime wrongly referred to as Pareto optimality) is used by economists to define the efficient organisation of the economy. Pareto efficiency refers to the allocation of resources such that someone can be made better off while no one else is made worse off. Hence there has been an efficient means of production and distribution of resources. When this does not happen, there has been market failure. This notion underlies neo-classical economics and is an important consideration in understanding the notion of economic regulation which is the topic of consideration here.

A distinction is made by many people between positive accounting theory (PAT) and what they call normative accounting theory. PAT emerges from positive economics. In discussing market failure and regulation a similar distinction is made by some. That is, there are analyses of regulation which are derived from positive economics and some from normative assumptions. These are described as theories of regulation. All can be viewed as some type of interest theory – primarily public or private but with "in-between" types.

Public Interest Theories

Advocates of the public interest theories of regulation see its purpose as achieving certain publicly desired results which, if left to the market, would not be obtained. The regulation is provided in response to the demand from the public for corrections to inefficient and inequitable markets. Thus, regulation is pursued for public, as opposed to private, interest related objectives. This was the dominant view of regulation until the 1960s and still retains many adherents. It is generally felt that determining what is the public interest is a normative question and advocates of positive theorising would, therefore, object to this approach on the basis that they believe it is not possible to determine objective aims for regulation; there is no basis for objectively identifying the public interest.

There are other charges laid at the feet of the public interest approach. These include attention being directed to the regulators themselves. Is it possible for them to act in a disinterested manner? Are they sufficiently competent? As might be expected such critics suggest there may be questions of the reward structure for regulators (being insufficient), their career structure and training may be inadequate. In addition it is often argued that the public interest approach underestimates the effects of economic and political power influences on regulation.

Interest Group Theories

An extension of the public interest theory is the interest group theory approach. Thus, regulation is viewed as the products of relationships between different groups and between such groups and the state. Advocates differ from public interest theorists in that they believe regulation is more competition for power rather than solely for the public interest. Baldwin and Cave (1999, p 21) suggest a range of interest group theories from open minded pluralism to corporatism. The former see competing groups struggling for political power with the winners using their power to shape the form of regulation. On the other hand, corporatists emphasise the extent to which successful groups enter into partnership with the state to produce “regulatory regimes that exclude non-participating interests” (p 21).

The Economic Theory of Regulation

The public interest theory of regulation is regarded as responding to a weakly defined demand for regulation. The positive or economic theory of regulation was introduced by Stigler in an article in 1971 It was later extended by one of his students, Peltzman, and has greatly influenced thinking on regulation theories. With many slight variations in interpretation this type of theory goes under a variety of names:

Economic theory,
Private interest theory,
Capture theory,
Special interest theory,
Public choice theory,
and probably many more.

Emerging from Chicago it is seen as a positive (economic) theory in which Stigler attempted to provide a theoretical foundation for an earlier notion of political theory that regulatory agencies are *captured* by producers. As a positive theory it assumes that regulators (political actors) are utility maximisers. Although the utility is not specified it would seem to mean securing and maintaining political power (Majone, 1996, p 31). In order to do this they need votes and money, resources able to be provided by groups positively affected by regulatory decisions. Thus, the regulators have been "captured" by such (special) interest groups who "seek to expropriate wealth or income. Income may take various forms, including a direct subsidy of money, restrictions on the entry to an industry of new rivals, suppression of substitute and competitive products, encouragement of complementary products, and price fixing" (Stigler, 1971, pp 3-7)

This approach to regulation is consistent with *public choice theory* which stresses the extent to which governmental behaviour is understood by envisioning all actors as rational individual maximisers of their own welfare. Analysis is directed to the competing preferences of the individuals involved – how they get around regulatory goals in order to further their own goals. Consequently private interests are served rather than the public interest. Public choice theory reconciles political and economic questions. It relies on the neo-classical economic assumption of rational choice (self interest) to predict the behaviour of politicians (the regulators) – politicians only enact those policies that ensure their re-election which, as described above, will direct them to those with the resources to further this aim.

The economic theory approach to regulation has encountered many problems for which it has been unable to provide solutions. When a theory meets problems for which it has not response, theorists add "extensions" or ad hoc hyptheses in an attempt to save the underlying theory. For example, Stigler's theory did not explain the phenomena of cross-subsidisation – where the economic benefits of regulation extend from the intended group to other groups of producers and consumers. His student, Pelztman attempted to extend the original analysis but he also failed to provide convincing conclusions to critics. However, another Chicago colleague, Gary Becker did reach a more acceptable explanation but he did so by combining elements of positive and normative theories, or, the economic theory and the public interest theory![2] Another major problem of economic theories is that they are unable to explain regulation – that is, there is no converse of their explanation for regulation.

Majone (1996) concludes that "positive and normative theories of regulation should be viewed as complementary rather that mutually exclusive" (1996, p 34). However, neither include an explanation for the institutional framework of regulation. Institutions were regarded as "black boxes" from which regulation emerged.

[2] See Majone (1996, pp 32-34) for a fuller explanation. Baldwin and Cave (1999, pp 24-25) describe other instances such as the work of Bernstein's "life-cycle" theory which, interestingly, also encompasses both economic and public interest theories.

Institutional Theories

A group of regulation theorists who reject the rational actor model have argued that the institutional structure and arrangements as well as the social processes shape regulation and therefore need to be understood. There is much more than individuals' preferences that drive regulation and that is the organisational and social setting from which the regulation emerges.

> Regulation is thus seen as shaped not so much by notions of the public interest or competitive bargaining between different private interests but by institutional arrangements and rule (legal and other). (Baldwin & Cave, 1996, p 27)

Institutional theorists (often called new institutionalists[3]) come from a wide variety of disciplines with a wide range of political and social predilections but all share a disbelief in atomistic accounts of regulation, that is, those explanations that focus on the individual. One form of institutional theory in the socio-legal literature draws on agency theory. The principals are the elected officials who then have to ensure that their "agents", the bureaucrats, design regulations that preserve the thrust of the original policy position. That is, that there is no bureaucratic drift. As with the agency theory in PAT, there is an information asymmetry in favour of the agents so the elected officials need to first design procedures that reduce the informational disadvantages faced by the politicians and, second, (so they can) ensure there are sufficient "dependable" administrators involved in the design of the regulation (cf Baldwin and Cave, 1996, p 28 who describe the work on this undertaken by McCubbins, Noll and Weingast; or see Majone, 1999, pp 35-37, for a discussion of other agency approaches to institutional theories of regulation and some of the difficulties involved)[4].

Institutional theorists in political science have concentrated on the way that "political structures, institutions, and decision-making processes shape political outcomes" (Baldwin and Cave, p 29). Institutional organisational theorists have focussed on organisational structures and processes. Yet other institutional theorists question the assumption of conflict between public authorities and private interests (such as the agency theorists believe) and concentrate on the interrelation between public and private interests and the ever-changing character of these relationships.

The Political-Economic Theories

Most, but not all, of the above theoretical approaches have had a tacit assumption of a capitalist system based, sometimes loosely, on a neo-classical economics. There are some "radical" theories which reject the neo-classical assumption and some of these are discussed by Tinker (1984). Capitalism is a social system in which there is interplay between the political and economic realms. In neo-classical theory it is assumed that the

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[3] They are referred to as *new* institutionalists to distinguish them from the institutional economists of the early twentieth century (eg Veblen)

[4] A very popular television program in the 1980s and 1990, *Yes Minister*, illustrated the difficult relationship between the politician and the bureaucrat.

political realm is shaped by economic interests. Employing the work of Lindblom, Tinker argues that there are many social inequalities among social classes which arise from the degree of access to and use of property and reliance on the market place. Regulation is necessary to move towards balancing some of the inequalities and, in effect, ensure the survival of capitalism. Such regulation serves "to protect the general or collective interests of capital and the requirements of the capital accumulation process" (Tinker, p 66). Tinker contends that the neo-classical economic framework is inadequate to characterise the need for regulation. Such economics is reductionist in that its advocates hold it is universalistic – it applies in all places at al times. However, Tinker, claims, there are many other social factors that need to be included in any analysis of regulation.

The analysis of regulation by Puxty et al (1987) can also be labelled as taking a political-economic approach although it is different from Tinkers. Their approach is more specifically directed to the how and why of accounting regulation and they discuss this in respect of four countries, viz, the then Federal Republic of Germany, the UK, Sweden and the USA, all which are described as advanced capitalist countries. Despite the similarities in the countries discussed they note that regulation will be shaped "according to the contrasting histories, cultures and paths of development of different nation states" (p 275). Thus, there analysis also rejects the reductionism of the neo-classical economic approaches. They build their argument from the work of Streeck and Schmitter who see that regulation emerges from the interplay of the three principles of social order – market, state and community. The original authors' analysis sees regulation as part of a "composite order in which (there is) a delicate balance between three formally incompatible, yet substantially interdependent, guiding principles of coordination and allocation" (p 277). Therefore, what is important to note is that regulation is viewed as going much beyond the purely economic (as in the neo-classical approaches) and will reflect broader cultural and societal values.

It is very important to understand the different approaches to regulation. Traditionally, discussions of regulation in accounting texts have merely mentioned the private and public interests theories in the context of accounting standards. However, regulation extends well beyond standard setting and has implication for how professions are organised, how they operate and what broader social expectation there of them. For example, the nature of the regulatory framework will affect perceptions of social responsibilities and ethical behaviour. There are many more implications of regulation than discussed above. There are implications of power and dominant ideologies that shape that power and consequent economic activity within a society. For example, what are the societal expectations of the governance of the major institutions of economic activity – corporations? Why are there spectacular corporate failures? How is it that corporations can shape the economic activity within a state?

Regulatory Strategies

The right choice of regulatory strategies by regulators will avoid debates over the need for the regulation if the relevant objectives could be achieved in ways other than the particular regulation. Thus, there are a number of basic strategies that regulators may employ and Baldwin and Cave (1996) describe several. These include:

Command and control

This is where regulators take a clear stand as to what activities are considered acceptable and what not with strictly enforced and severe penalties imposed on the latter. Examples would include work and safety regulations with which businesses must comply – strict standards are imposed. There are some issues with this regulatory strategy. First, it has been shown that because a close relation between the regulator and the regulated develops the regulators may be captured by the regulated. Walker (1987) has suggested this is what happened in the case of the early development of the Australian Accounting Standards Review Board. Secondly, this strategy often leads to overly strict and inflexible and even a proliferation of rules. Thirdly, it is often extremely difficult to decided on what standards are appropriate. In these situations the standard setting should be balanced against the potential for anti-competitive behaviour – that is, insisting on such uniform standards that it is difficult to distinguish providers. Finally, there are issues over enforcement. For example, enforcement might involve the appointment of many inspectors of bodies charged with enforcing the many rules: how can equity be maintained and complaints avoided?

Self-regulation

This is a less severe regulatory strategy then command and control. It is usually employed in relation to professional bodies or associations. Such organisations develop systems of rules that they monitor and enforce against their members. This is what the accounting profession fought hard to maintain. Generally acceptable accounting principles and later accounting standards were developed by professional accounting bodies to avoid government control of accounting practice. Some people are not convinced about the effectiveness of self regulation, such as the ability of a body to enforce regulation directed against some behaviour of its members. For example, can a body overseeing honesty in marketing rule against an advertising agent on the basis of its prepared marketing material? There are questions of openness, transparency, accountability and acceptability of the process. In addition, the rules written by self-regulators may be self-serving and difficult to be shown to have been contravened. Criticism of this sort has been levelled against many accounting standards or principles, For example, the question of inventory valuation which in turn requires assumptions about inventory flows (LIFO, FIFO etc) led to several thousand permissible techniques of inventory measurement.

Incentive-based regulation

Although it is usual to think of taxes being used as a penalty to discourage certain activities, taxes can be used as a positive incentive. For example, for many years firms in Australia were allowed a tax incentive for the purchase of some items of plant and equipment or expenditures on research and development or the cost of employment of apprentices. These can be general (nation wide) or localised (for items used in certain areas or industries). The advantages of such an approach to regulation is ease in enforcement (the regulated have to make claims for the incentive) but the disadvantages include the difficulty in predicting the effectiveness of the incentive schemes.

Disclosure regulation
Advocates of the disclosure of information mode of regulation claim it is not heavily interventionist. It usually refers to the requirements of product information, such as the food value of a pre-packaged food, whether the product is organically produced, environmentally friendly, the country of manufacture/origin and so on. Arguments could be made that this could also relate to the disclosure of financial information although this is not the usual connotation.

Once again, the above are just a few of the many possible regulatory strategies. A full understanding of regulation would require a much deeper analysis of the many aspects associated with the imposition of regulation. Regulation is used to direct society's action in a way considered the best for that society. Just how this "best" is determined will involve many deep questions of power and ideology. "To decide whether a system of regulation is good, acceptable, or in need of reform it is necessary to be clear about the benchmarks that are relevant to such an evaluation" (Baldwin and Cave, 1996, p 76). A typical economists' reaction would be to associate good regulation with efficiency and wealth maximisation. This does not give any indication of ethical efficacy nor the appropriateness of the distribution of that wealth. It will be couched in terms of a time frame such that what may produce maximum wealth in the short term may cause significant environmental damage costs that have to be borne by those in the long term. Such analyses may rely on artificial and abstract concepts such as utility, happiness or justice. The term **hegemony** refers to power exercised by one social group over another. It is the capacity of a dominant group to exercise control through the willing acquiescence of others in society to accept subordinate status by their acceptance of cultural, social and political practices and institutions that are unequal and unjust (cf Johnston et al, 2000, pp 332-334). The word was originally used in a more radical sociological critique but now is used to refer to dominant political and economic interests. Therefore, if wealth distribution is on the basis of wealth maximisation there is a given distribution pattern which reflects the past and thus reinforces the interests of an economic hegemony. This is part of capitalism. Even though "All over the world there is a concern that governments are captured by organised business interests" (Mitchell et al, 2001, p 3), capitalism emphasises the hegemony of business interests and accountants have long tacitly complied with and reinforced this state of affairs. Some even claim that accountancy associations have "a long history of opposing reforms, which have sought to make corporations accountable" (Puxty, Sikka and Willmott, 1994, quoted in Mitchell et al, 2001, p 10). This antisocial conduct, Mitchell et al continue, is "highly visible in relation to auditor obligations for detecting/reporting fraud". The authors continue to show how accountants, even those in the largest multinational accounting firms, have designed tax schemes to enable their business clients avoid paying taxes[5] and also been complicit in schemes of money laundering.

The "justification" of an even more cynical approach of business to regulation emanates from the University of Chicago law and economics movement. This is that regulation will

[5] See also, Mitchell, A, P Sikka, J Christenen, P Morris and S Filling (2002), *No Accounting for Tax Havens*, Basildon, Essex, AABA

only be obeyed when the costs of disobedience exceed the benefits. Thus, compliance becomes a business decision not a societal decision: it is an application of strict cost-benefit analysis irrespective of the societal implications. There are many instance in the daily media of business interests ignoring environmental, health and safety, employment and other regulations knowing their non-compliance will attract a fine which they seem content to bear. The fine simply becomes a cost of production which can later be transferred to the consumer! It is this type of thinking that led to such spectacular corporate collapses as Enron, World Com, Parmalaat, HIH and many others (see Clarke, Dean and Oliver, 2003).[6]

It is for these and other reasons that many commentators argue that regulation cannot be assessed on purely economic grounds. Tinker argues that the current economic hegemony - neo-classical economics – cannot fully resolve issues relating to regulations.

> . . . . the inability of the economic-finance literature to say anything definitive about the appropriate form of accounting regulation highlights the need to augment neo-classical economic analysis with sociopolitical considerations (1984, p 55)

That is, there are much wider social implication of regulation which neo-classical economics simply ignores (cannot answer according to its theoretical percepts).

Similarly, Puxty et al have turned to broader theories of the state in order to assess the accounting regulation in their four country case study because

> The institutions and process of accounting regulation in different nation-states cannot be understood independently of the historical and political-economic contexts of their emergence and development (1987, p 275)

Accounting and Regulation

Over the years commentators have not been unaware of the need to view regulation in a broader framework. Some, while recognising the political implications in the process of regulation have argued that political considerations be excluded and that accounting remain only concerned with measuring the "facts" (Solomons, 1978). In light of the above discussion, taken at face value, this sentiment would seem unduly naïve. However, over the years it has been the hallmark of much accounting debate: that is, the false belief that accounting is value neutral and only concerned with reporting the economic facts!

For most of the twentieth century the accounting profession sought to maintain a regime of self regulation. Accounting professional bodies worked hard to avoid the imposition of regulation on the discipline. For this reason the professional bodies have attempted to develop, first generally accepted accounting principles (GAAP) and then a conceptual framework that would serve as the basis of an accounting theory. Most of the

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[6] Certainly not all business acts this way – consider this statement in the 2004 HSBC Corporate Social Responsibility Report (p 4):
While our strategy involves growing revenues by meeting customer needs, our goal is not, and never has been, profit at any cost. We know that tomorrow's success depends on the trust we build today.

developments took place in the USA and therefore the approach to regulation was the United States approach described above. That is, confidence was maintained in the operation of the market with regulation seen as necessary to provide rules to correct the slight imperfections in the workings of the market. There is a paradox in that the principles, standards and other associated factors were viewed by many as necessary for the development of an accounting theory yet accounting practice was seen as only needing “minor corrections” to be able to work efficiently (in the market). The search for GAAP and a theoretical framework has been a struggle for the discipline and its members. Widely differing viewpoints on the necessity and form of regulation have resulted in considerable tensions. The involvement of accounting and accountants in spectacular corporate collapses and major case of business fraud has ensured the need for accounting regulation. Thus, there has been a public interest concern that has created the regulation. That is, pressure from various sections of society has demanded regulation.

This was similar to what happened in the 1930s when the US Government (regulation) created the Securities and Exchange Commission (SEC) in the 1930s. The background to this was the economic depression and more particularly the stock market crash which hurt many people. A first reaction would be to suggest that the regulation was a result of “public pressure” and hence it was a result of the public interest. However, as Tinker (1984) has shown there are diametrically opposite interpretations of this event. Benston adopts a free market, economic approach and argues that the legislation damaged capitalism (investment) and should be repealed (to permit the free operation of the market). His argument adopts a group interest interpretation as he attributes the “responsibility for the continuance of securities legislation to self-serving journalists, academics, lobbyists, and government officials” (Benston, quoted in Tinker, p 67). He believes the legislation should have been repealed in the (private) interests of capitalism. On the other hand Merino and Neimark argued that the legislation served to “protect” capitalism. They employ a public interest perspective. They agued that there was considerable public pressure for the legislation which was “essential to the preservation and reproduction of capitalist social relations” (Merino and Neimark, quoted in Tinker , p 66), that is, the growth in public investing in US .corporations.[7]

After some heated debate the SEC delegated the development of accounting principles to the profession – there was from then self regulation by the profession. However,

> All has not been smooth between the SEC and the private-sector standard setter. During the 1940s and early 1950s, when the two parties were learning how to relate to each other, the SEC took issue with the Committee on Accounting Procedure on several matters: interperiod tax allocation (i.e., deferred taxes), all-inclusive v. current-operating-performance concept of the income statement, stock options, and upward asset revaluations. During the 1960s, the SEC succeeded in pressing the APB to "narrow the areas of difference" in accounting practice on such topics as pensions, extraordinary items, and deferred taxes. (Zeff, 1995, p 52)

[7] By 1940 there were about 4 million investors, by the 1950s this number was about 7 million and by the 1960s this had grown to 20 million.

The heated debate between the SEC and the accounting professional bodies continued throughout the rest of the twentieth century and it raises questions about the appropriateness of self regulation. There are specific problems in the discipline of accounting and they concern the issue of independence. There are many interrelated concerns in respect of independence. Initially accounting firms earned most of their income from fees for auditing. The first concern is that the accounting firm is investigating its employer so there is an initial conflict of interests. The accounting professional bodies through their agencies are supposed to ensure that the possible conflict of interests between auditor and client does not arise – that the highest standards of "professionalism" are maintained. The professional body comprises members of the accounting firms whose work is being monitored and regulated by the professional bodies – another potential conflict of interests which is made acute if the accounting firm has any power over the professional body. This has clearly been shown to be the case in very many instances – the big accounting firms heavily influenced the professional (private) regulators.

Many of the problems associated with the conflicts of interest have come to light with some of the corporate failures early this century.

The Sarbanes-Oxley Act

This was especially true in the United States after the dramatic corporate scandals such as the Enron, Tyco International and World Com cases. Public pressure on the government resulted in the passing of the Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as the Sarbanes-Oxley Act (often abbreviated as SOX) after the politicians who were instrumental in establishing the Act[8]. The Act established the Public Company Accounting Oversight Board (PCAOB) which, interestingly, is not an agent of the government but an independent nonprofit corporation. However, there are many requirements that ensure the PCAOB works with and reports to the SEC.

Section 103 of the Act states that:

> The Board shall:
> (1) register public accounting firms;
> (2) establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;"
> (3) conduct inspections of accounting firms;
> (4) conduct investigations and disciplinary proceedings, and impose appropriate sanctions;
> (5) perform such other duties or functions as necessary or appropriate;
> (6) enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto;
> (7) set the budget and manage the operations of the Board and the staff of the Board.

[8] The full Act can be accessed at: http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf

Thus, despite the “official status” of the PCAOB it means that the government has become involved with regulating (some) accounting activities. In fact, as paragraph (6) states, the PCAOB is required to be involved in regulation, most specifically, auditing standards (especially those relating to internal control procedures). It is also interesting to note that despite the Act, in October 2005, a survey by the Wall Street Journal (21 October 2005) found that 55% of US investors (77% males between the ages of 45 to 54) believed that financial and accounting regulations governing publicly held companies are too lenient.

The Sarbanes-Oxley Act resulted from public pressure and is therefore an example of the public interest approach to regulation. Similar pressures were in place prior to the passage of the US Securities Act in 1934 which resulted in (amongst other things) the creation of the SEC and this seems to add weight to the Merino and Neimark interpretation rather than that of Benston described above. In addition, Sarbanes-Oxley was a blow to the accounting profession’s extensive efforts, since the passage of the Securities Acts of the 1930s, to maintain a regime of self regulation.

Enforcing Regulation

A criticism often levelled at self-regulation concerns enforcement. Professional accounting bodies have disciplinary committees designed to enforce the relevant regulations. However, how effective is this process? There are issues of politics and power. For example, would the accounting bodies have taken action against a major accounting firm if there was evidence of some of its member acting inappropriately? Some suggest had they done so there may have been fewer corporate scandals.

There are various approaches that have been used to ensure enforcement of regulations. These vary from **compliance** approaches to **deterrence** approaches. With the former the aim is to encourage conformity with the regulation; with the latter, prosecutions are used to deter future infractions. The US approach to accounting standards is said to be **rules based** so its emphasis is on deterrence. In other countries such as Australia, and the position adopted by the International Accounting Standards Board, the approach is said to be **principles based** so the emphasis is to ensure users can theoretically justify use of an accounting technique – does it comply with the intention behind the regulation? However, the issue is not that simple because if a system is rules based then it is important to have rules that are sufficiently precise, extensive and understandable. This may well be why the US has so many accounting standards and why there is an emphasis on standards education!

Deterrence approaches are said to be more direct and definite and more effective in eliminating errant conduct. They are “tougher” than compliance approaches and it is therefore more rational to comply. Compliance approaches are, it is argued more susceptible to capture and a lack of sufficient enforcement resources. On the other hand, compliance proponents argue it is more efficient and less costly because the process of prosecution is extremely costly. It is also more flexible and less confrontational which in turn encourages compliance. Ayres and Braithwaite have suggested that “The trick of successful regulation is to establish a synergy between punishment and prosecution" (quoted in Baldwin and Cave, 1999, p 99).

From the comments by the then Chairman of the SEC, Harvey Pitt, it is clear that in the US there is the intention of a deterrence approach as he has suggested that it is clear that the SEC "should be empowered to perform investigations, bring disciplinary proceedings, publicize results, restrict individuals and firms from auditing public companies" (Pitt, 2002).

Regulation, Research and Theory

The subject of regulation is very wide ranging and is very important. There are very many viewpoints as to the purpose, the need for and the operation of regulation. Not only can regulation be viewed as market failure it can also be seen as "theory failure". In accounting the profession strenuously pursued a search for an underlying theoretical structure through GAAP, standards and a conceptual framework. Had the profession been successful there would have been less need for the intervention of the state in regulating the discipline; so, in this sense it is the failure of those in the discipline of accounting to provide a theory that has necessitated the intervention – or at least to the extent that there has been. Economic purists argue that there should be no need for regulation as the market can operate to ensure the fair distribution of resources. There is a paradox in the free market argument as history has shown that considerable regulation has been necessary to ensure that the market can operate reasonably efficiently[9].

Both these positions – "theory failure" and totally free markets – are simplistic in that they ignore the broader social setting of the discipline. Once again, history demonstrates that no amount of theory or regulation will prevent some people engaging in inappropriate activities. For example, complex income tax legislation does not prevent tax evasion schemes being devised by some accountants. Accountants will still be involved in corporate fraud and collapses. Accounting is a social discipline and cannot be isolated from the broader implications of those who prepare accounting information and those who use it. Very simply stated, there will always be ill-intentioned accountants and users of accounting information who will not act in the interest of society. This of course is true of most professions – for example, medical doctors taking drugs, lawyers devising criminal schemes to avoid justice, engineers using inferior materials to cut costs of projects and many other similar situations. Therefore, whether we like it or not, societies have seen fit to impose some safeguards against such actions – professional and other sanctions – in the form of regulation.

With rapid societal changes brought on by advances in information technology and the pressures of globalisation the need for systems safeguarding social interests has become more acute and there have been greater demands from the public. This would suggest a reversion to the regulation for the public interest motive. However, the situation is more

[9] This is emphatically demonstrated in the regulation of employment introduced by the Australian Government in 2005 where, for example, there is a highly complex system of employer fines if they contravene how the Government sees the operation of "free" market!

complex and, whereas there are many instance of the public interest motive for regulation there are also many examples of all the other approaches described earlier in this paper – group interest, private interest and for institutional reasons. In fact, it is difficult to discern which approach is relevant to much of the regulation as it seems to be a combination of many approaches.

There is also difficulty in determining the public interest. So, while the AICPA Code of Professional Conduct describes it in general welfare terms[10] (a public interest approach) one official of that same body argues that the public interest of the AICPA should emphasise investors and creditors in capital markets (a neo-classical economic approach) (Baker, 2005 pp 693-695). However, there is little doubt that any regulation is a political process but there are very different interpretations of what this means. Watts and Zimmerman (1978) in examining the need for accounting regulation (standards) argued, some time ago, that this political process worked to serve the interests of individual and groups of academics. As Tinker states, "academics are reduced to intellectual mercenaries who advocate greater regulation to maximize their own wealth" (1984, p 59). Thus, Watts and Zimmerman adopted a private interest or group interest approach to regulation.

Irrespective of the approach adopted there is little doubt that regulation will be the result of the interplay of political forces. How these are manifest will vary from situation to situation. These forces have, over the years, impacted on and will continue to directly influence the practice of accounting through the various forms of regulation that have been imposed on accounting and accountants.

[10] Section 53.02: "The public interest is defined as the collective well-being of the community of people and institutions the profession serves"

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