The Informational Effect of Corporate Lobbying Against Proposed Accounting Standards

DENNIS Y. CHUNG
Assistant Professor, Department of Accountancy, The Hong Kong Polytechnic University, Hung Hom, Kowloon, Hong Kong. Email: acdchung@smtpgwy.polyu.edu.hk

Abstract. Accounting standard setting has been described as a highly political process. Different interest groups are often quite ready to criticize any proposed accounting standard and lobby the accounting standard setting body. This study explores the possibility that certain information might be revealed through corporate lobbying behavior. A game-theoretic model is formulated to examine the implications of a proposed accounting standard which, if passed, would require the financial statement recording of some previously undisclosed liabilities. In this model, management has incentive to lobby against the standard and prevent the mandatory reporting of the liabilities. Lobbying against the standard, however, may itself reveal to the market information about the liabilities. Results of the equilibrium analysis show that, because of this informational effect, a company may choose not to lobby even though the company may have a high liability and can be adversely affected by the proposed standard. On the other hand, a company may avoid revealing its liability level if it can adopt the “always-lobby” strategy. Furthermore, a company may not have to lobby at all if it can “free-ride” on other companies’ lobbying effort. Companies may even be able to enjoy “free-riding” at least some of the time if each company can share the responsibilities and lobby on a probabilistic and what otherwise may seem like a random basis.

Key words: Management lobbying, accounting standard setting, game-theoretic model, free-riding

1. Introduction

The setting of accounting standards plays an important role in affecting how, when, and where corporate financial information is disclosed. With the often diverse and conflicting interests of financial statement users, there rarely exists an accounting standard that is acceptable to all parties involved.1 The complex process of accounting standard setting involves the interplay of power and influence among many different groups (Lowe, Puxty and Laughlin 1983; Thompson 1987). As many have argued, it may be the political competence and not necessarily the technical competence of an accounting standard that can most affect the effectiveness of the standard (Horngren 1973; Gerboth 1973; Sunder 1988). Concerns about the effects of moving accounting standard setting into the political arena have been raised and are still being debated (e.g., Gorton 1991; Sharav 1995; and Beresford 1995).

One way special interest groups can influence the setting of accounting standards is through lobbying. Corporate lobbying by management can take on many different forms (Hope and Briggs 1982; Hope and Gray 1982).2 Most accounting standard setting bodies, such as the Financial Accounting Standards Board (FASB) in the U.S., follow thedue
process of public consultation. This study examines the informational effect of the overt form of corporate lobbying carried out by management in its attempt to influence the outcome of the accounting standard setting process. Management’s submission of comment letters and public oral presentation on specific exposure draft issues are examples of such activities.

Studying corporate lobbying on accounting issues is important because it gives us insights into understanding the unique institutional features of the accounting standard setting process. It is generally believed that accounting standards are intended to enhance the quality of accounting information and to reduce information asymmetry among market participants (Scott 1997, pp. 368–370). While due process is a major feature in accounting standard setting, how management participates in this process may also generate important information effect. By lobbying today on a standard which may affect how information has to be disclosed in the future, management may be revealing some information through the act of lobbying itself. This, in turn, will affect management’s lobbying behavior and the informational setting. An interesting problem for the accounting profession and the standard setter is to understand how the standard setting process may be affected by its own impact on information asymmetry.

2. Prior research

Positive studies have been widely used in accounting to examine corporate lobbying behavior (Watts and Zimmerman 1978, 1986; Dhaliwal 1982; McKee, Bell and Boatsman 1984; Kelly 1985; O’Keefe and Soloman 1985; Francis 1987; Sutton 1988; Deakin 1989; and Ndubizu, Choi and Jain 1993). Firm size and expected wealth effects have been found to be significant determinants of management’s lobbying position. These studies, however, could account for only between 20% to 60% of the variance in lobbying choices suggesting that other important factors might also be affecting management’s lobbying decision.

Corporate lobbying and standard setting were also studied in other contexts. Kelly (1982) and King and O’Keefe (1986) examined the economic consequences of proposed accounting standards and suggested that lobbying positions expressed in comment letters are informative to the standard setter. Haring (1979), Brown (1981), and Puro (1985) examined the influence of special interest groups and their lobbying positions relative to each other. Meier, Alam and Pearson (1993) reported that the wealth effect was also significant in explaining the auditor’s lobbying position relative to the client’s position. Sims and Cullis (1995) studied the qualitative characteristics of financial information and their importance as perceived by different lobbying parties. Buckmaster, Saniga and Tadesse (1994) focused on measuring the extent to which different lobbying parties could influence the standard setting body. Lobbying was also studied in a policy-making context by Hope and Briggs (1982) and Gorton (1991) and under a framework of power by Hope and Gray (1982) and Booth and Cocks (1990). These studies provided evidence that accounting standard setting is a highly political process. Along the line of capital market research, Noreen and Sepe (1981), Smith (1981), Schipper and Thompson (1983), Ziebart and Kim (1987), and Espahbodi, Strock and Tehranian (1991) examined the stock mar-