POLITICAL STANDARDS

Accounting for Legitimacy

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Preface

In subtle but significant ways, our corporate accounting system has been captured. This is disturbing for at least two reasons. First, because accounting rules are at the heart of our market economy. They define the fundamental notion of profitability, facilitate capital allocation across competing ventures, and ensure the accountability of corporations and their managers. The health of the accounting system impacts the health of the economy and the distribution of wealth and income therein. Second, because the evidence of capture in accounting rule-making can be symptomatic of a broader problem with how the “rules of the game” in our market economy are determined – particularly esoteric and highly technical rules that are outside the understanding and oversight of the general public. For example, the rules around bank governance and supervision, the rules around corporate auditing, and the rules around risk management and disclosure in financial firms.

This book assembles a large body of evidence on the political process of corporate accounting rule-making particularly in the United States. It studies the role of individual corporations, investment banks, asset-management firms, audit firms, industry associations, and members of the Financial Accounting Standards Board – the private, not-for-profit body charged with making U.S. corporate accounting rules. It evaluates the workings of the rule-making process. Does the process generate rules that are in the general interest – that is, likely to facilitate investment-allocation efficiency and corporate accountability in our market system?

In several instances, I find evidence of rules that benefit one or more special-interest groups – industrial corporations, financial firms, and audit firms – at the potential expense of the general interest. In other words, the evidence suggests special-interest capture of the accounting rule-making process. This finding is of added import because accounting rule-making is an illustration of a distinctive kind of regulatory challenge – producing public policy in a thin political market. Accounting rules cannot be determined without the substantive expertise and experience of special-interest groups that, by definition, also have strong commercial interests in the outcome and enjoy little political opposition from the general interest because of the abstruse nature of the subject matter. The challenge of such a thin political market is producing policy that is in the general interest.

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This book is aimed at a wide range of participants and observers in the market economy, including corporate managers, market-policy makers, and business scholars. No specialist knowledge of accounting is necessary – the book is self-contained with regards to technical concepts that are relevant to interpreting the evidence. The evidence in this book spans nearly four decades of data and is drawn from both large-sample formal statistical studies and in-depth case studies. Most of this evidence has been vetted through the academic peer-review process and published in scholarly journals in accounting. The basic findings are as follows:

- With the financialization of the U.S. economy, particularly, since the 1990s, we see a growing impact of investment banks and asset-management firms in accounting rule-making. These groups are more likely to propose rules that accelerate financial-statement recognition of anticipated economic gains – fair-value accounting rules. Under certain circumstances, this can result in higher compensation to executives in these firms.
- The rules above are difficult to audit because they require verification of conjectural profits. Large audit firms have responded by lobbying consistent with desiring more check-the-box style rules (in contrast to rules that require subjective judgment). Check-the-box style rules can lower auditors’ legal and political liability in case the conjectural profits do not materialize; such rules can also lower auditors’ overall accountability in the system.
- Members of the FASB generally propose rules consistent with the interests of the industries from which they hail – members from investment banking and asset-management generally propose fair-value accounting rules.
- Managers in non-financial firms lobby on issues of particular relevance to them; they generally lobby for rules that further their private interests. On other issues they are mostly silent.
- Some large private firms (firms not listed on stock exchanges), concerned particularly about the compliance costs of fair-value accounting rules, have been part of a successful coalition to create a new accounting rule-maker for themselves – the Private Company Council. This despite a dearth of conceptual arguments for separate accounting rules for private companies.
- There is evidence that the impact of special interests on accounting rule-making is not limited to the United States. This appears to be an international and even a global phenomenon.

Three themes emerge from across the findings: First, corporate accounting rule-making is largely determined by a few specialist individuals (mostly corporate executives, bankers, and auditors) with strong economic interests in the outcome. They experience little political opposition in the process, particularly from those representing
the interests of retail investors and, more so, ordinary citizens. Second, the outcome is, in several instances, skewed toward the interests of the specialists in ways that can compromise accounting’s role in corporate performance evaluation, corporate accountability, and asset allocation. Put differently, there is evidence suggesting that the accounting system has been “captured” by special-interest groups. Third, perhaps most importantly, the evidence does not point to systematic and sustained capture by any one special-interest group. There is no single extractive institution; no unequivocal villain in the story. The capture in accounting rule-making appears to be ad hoc and driven by those with the strongest economic incentives in any particular case.

Several books have been written on regulatory capture – or attempts thereof – in different areas of the economy, including federal broadcasting standards, automobile safety standards, and pharmaceutical approval standards. This book adds to the corpus of regulatory appraisals by offering a broad evaluation of the political process in accounting rule-making – a critical market institution that is rarely subject to wide-ranging assessment. But beyond that, the book develops the notion that accounting rule-making is a “thin political market” – a notion that can have implications for several other areas of regulation.

I argue that the three themes emerging from the analysis of accounting’s political process together structure a special class of problem in the creation and maintenance of market institutions that underlie capitalism – the problem of a thin political market. I define a thin political market as an area of rule-making or regulation relevant to the functioning of capitalist economies, where corporate managers: (a) possess the technical expertise necessary for informed regulation, (b) enjoy strong economic interests in the outcome, and (c) face little political opposition. Beyond accounting rule-making, areas such as banking and insurance regulation, rule-making for corporate governance and control, and even rule-making for nuclear-plant safety are likely thin political markets.

Thin political markets are distinct from political processes where the general public is sufficiently informed or incented to participate – e.g., the political market for Social Security reform. They are also distinct from political processes where expertise for regulation does not necessarily reside with corporate interests – e.g., the political market for environmental regulation, where climate scientists possess substantial know-how. The co-mingling of regulatory expertise and economic interest within corporations, together with the paucity of political opposition (due partly to the highly technical nature of the underlying subject matter), makes thin political markets particularly challenging.

In a thin political market, it is difficult for non-vested interests to design precise regulation in the general interest. Independent experts – e.g., accounting professors in the case of accounting rule-making – have modest impact in thin political markets because
their “independence” generally correlates with distance from the substantive experience necessary for regulation. *Ex post facto* studies – such as the kind in this book – can bring circumstantial evidence to bear on the likelihood of capture. For example, research presented in this book shows that (i) several important accounting rules deviate from what is expected given accounting’s role in performance evaluation, asset allocation, and stewardship and (ii) this deviation can be explained by the interests of those with relevant experience. But this assessment is after-the-fact; not concurrent, not preventative.

So, what can we do about the problem of thin political markets?

The various actors in the accounting rule-making game are all individually acting in their own interests – seeking to increase their own profits in a manner that is not obviously illegal. Indeed, on one level, their actions essentially embody the capitalist spirit as articulated in Milton Friedman’s famous claim that “The social responsibility of business is to increase its profits.” But the logic of profit-increasing behavior is the logic of competitive markets; and, as the evidence in this book demonstrates, this logic breaks down in thin political markets. I argue that when lobbying in a thin political market, corporate managers assume responsibility for the market system as whole and for the citizens in whose interests market capitalism functions. So, just as there is widespread recognition among managers of their agency to corporations and shareholders – recognition that is imbued in them via business schools and corporate codes as a moral duty – so too must managers recognize their agency of the system when lobbying in thin political markets. The book concludes with an urgent call to action in this regard.
1. Introduction

What follows is a detailed introduction to the book. A more concise summary of the book’s key findings and arguments is given in the preceding preface. I begin this introduction with an example from the area of accounting rule-making for corporate mergers & acquisitions (M&A). The example illustrates the phenomenon at the core of the evidence and analysis in this book – the problem of thin political markets. Later in the introduction, I provide an outline of the chapters that follow.

* * *

M&A between and across companies are a critical institution of our modern market-capitalist economy. They allow companies to fold into each other to unleash synergies that can sustain and grow the economy. Further, they constitute a core element of the “market for corporate control” – the process through which floundering companies and their managements are held to account by the rigors of the marketplace, embodying the creative destruction at the heart of capitalism. From 1980 through 2012, M&A activity in the United States totaled roughly $44 trillion, about 15% of U.S. GDP over that period. The central issue in M&A is the price to be paid in an acquisition – decades of academic research has revealed that managers often overpay in M&A, perhaps because they are overconfident in their ability to realize synergies or because they are unreasonably driven to build scale into their existing organizations.

Given that M&A can either generate value for shareholders and society or, alternatively, be misused by “empire-building” management teams, it is important to hold managers to account for their M&A activities, particularly for an acquisition’s purchase price. This is largely accomplished through corporate financial reporting. Without financial reporting that matches the costs of an acquisition to its benefits, investors could be led to reward managers who increase the scale of their companies but decrease their value through overpriced acquisitions. As such, accounting rules for M&A are a key accountability institution in capital markets. A particularly relevant area of M&A accounting – relevant to the purchase price of an acquisition – is “goodwill accounting.”

Goodwill is the excess of the purchase price in an acquisition over the current value of all purchased assets less the current value of all assumed liabilities. In other words, goodwill is premium paid over the verifiable value of the acquired firm. It represents the conjectural “future profits” that an acquiring manager hopes to realize through an acquisition. Research has shown that, on average, acquiring CEOs
How goodwill is accounted for is thus critical to the accountability of M&A transactions. Since 2001, the GAAP rules in the United States that govern goodwill accounting have compromised in subtle ways this accountability role. To see this requires a brief plunge into accounting principles: “Income” in accounting is defined as revenues minus costs. A core principle underlying traditional historic-cost accounting income is to match revenues to their associated costs. In other words, to get a useful income number for a given year, we want the year’s revenues to be matched to the costs – including investments from previous years – that were needed to generate those revenues. In the case of measuring income from an M&A, the revenues are those generated when imagined synergies become real sales to customers. The corresponding costs are numerous, but they include the value of goodwill acquired – that is, the premium paid in the M&A. Since the revenues from actualized synergies can occur over many years following an M&A in a process that is not measurable with any certainty, the traditional historic-cost way to account for M&A is to take a pre-determined proportion of a firm’s goodwill balance and treat it as a cost each year (e.g., 1/10th of the goodwill balance each year for ten years). In fact, this was the rule that defined goodwill accounting in several cases prior to 2001 – a process known as goodwill amortization.

But since 2001, firms have not been required to draw down their goodwill balance each year. Instead, they are given the option of determining for themselves whether their goodwill is “impaired.” Not surprisingly, a CEO who overpays in an M&A is not particularly keen to publicly acknowledge that overpayment, so instances of firms declaring their goodwill as impaired are rare. What this means is that if an M&A was successful – and the acquiring firm generates the synergies it imagined at acquisition – the firm’s income recognizes the revenues from those synergies but not all of its costs. This violates the basic premise of traditional accounting – it results in a double-counting of sorts. Alternatively, if an M&A is unsuccessful – and imagined synergies are for naught – investors and other users of accounting information can be left waiting for true accountability from managers – it takes a particularly earnest CEO to admit that he or she overpaid for an acquisition. In fact, research shows that goodwill impairment is more likely to occur under new CEOs, who take a “bath” on their predecessors’ accumulated goodwill balance.

Why would the goodwill accounting rule change matter if even a few sophisticated investors are able to undo its effects, reconstructing what firms’ income statements and balance sheets would have looked like under the old rules, through some

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a GAAP is an acronym for Generally Accepted Accounting Principles, the framework that guides the preparation of financial statements in a jurisdiction.
accounting analysis? Partly because summary accounting numbers such as net income and net assets – which are both affected by the rule change – are sometimes predictably associated with stock prices, reflecting market inefficiencies. And partly because such summary accounting numbers are used in a host of formal commercial contracts such as executive bonus contracts, debt contracts, and supplier contracts. As a matter of economy, these contracts are generally written on GAAP rules; it is costly for contracting parties to redefine accounting rules on an *ad hoc* basis.

Thus, one consequence of the goodwill accounting rules since 2001 is compromised accountability for M&A. Then, a natural follow-up question is: How did the 2001 accounting rules for M&A come to be?

The answer lies in a deeper understanding of the arcane process through which accounting rules are determined. At the heart of this process is the Financial Accounting Standards Board (FASB), the country’s accounting rule-maker. In 1999, the FASB, partly in response to pressure from the U.S. Securities & Exchange Commission (SEC), which oversees the nation’s stock markets and publicly listed securities, decided to reevaluate the accounting rules for M&A. What followed was an unusually long and political process that, importantly, involved the country’s biggest investment banks – Goldman Sachs, Merrill Lynch, and Morgan Stanley. Investment banks, by the nature of their business, have an interest in issues related to M&A, including the accounting rules used by their prospective clients. As the opportunity to revisit these rules came up, the investment banks became key players in the private rule-making process. First, they saw their allies in the U.S. Congress lambast the FASB for its initial proposed replacement to the extant M&A accounting rules. Then, representatives from the banks met with the FASB to advance their own proposals. They lobbied for rules that look very similar to those that eventually ended up as the final FASB standard on goodwill accounting. That is, they advocated the abolishment of goodwill amortization and the introduction of the rules for goodwill impairment.

To be sure, the old rule – goodwill amortization – was far from perfect; treating a pre-determined portion of a firm’s goodwill balance as an expense each year is arbitrary. Moreover, the SEC had been concerned about abuses of other extant M&A accounting rules (unrelated to goodwill per se), which was part of the impetus for the 2001 rule change. So compromised accountability for M&A under the current goodwill rules is the outcome of complex bargaining that comigned many issues. But given the repercussions of compromised goodwill accountability to the integrity of M&A and capital markets, there is, nevertheless, cause for concern.
How did a handful of special interests shift such a core accounting rule? Why was the shift not bigger news as it happened? Who looks out for the interests of common citizens and retail investors in the political process that determines the accounting rules?

In this book, I address these questions through a broad analysis of the corporate accounting rule-making process in the United States and beyond. Apart from the accounting community, this analysis can be of interest to scholars, policy-makers, and executives in business more generally. Because accounting rules are at the heart of measuring corporate performance, securing corporate accountability, and facilitating capital allocation in a market economy.

Since the early 1970s, corporate accounting standard setting in the United States has been formally vested in the FASB, a small group of accounting rule-makers, incorporated as part of a private not-for-profit organization, the Financial Accounting Foundation (FAF). But neither the FASB nor the FAF holds a congressional charter to make accounting rules for corporate America. Rather, this authority comes from the SEC, which has been charged by Congress since its establishment in the 1930s with the determination of accounting standards for publicly listed companies in the United States. The SEC has for almost all of its history relied on private bodies to draft and promulgate accounting standards. This delegation of public responsibility to private interests implicitly recognizes that neither Congress nor the SEC have direct substantive knowledge and experience in the matters that inform accounting standards. The expertise necessary to create accounting rules – facility with ever-mutating business practices, their evolving methods of account, and emerging technologies to audit such accounts – resides in the private sector.

But inherent in the idea of private rule-making is the fear that private interests will come to subvert the public’s benefit through opportunistic rule-setting. In fact, two private bodies were delegated the accounting rule-making role prior to the FASB – the Committee on Accounting Procedure (1939–1959) and the Accounting Principles Board (1959–1973) – and both these bodies met their demise in part because of concerns about their lack of independence from private interests. Speaking in 1971 of the need to reevaluate extant institutions of accounting rule-making, the then president of the American Institute of Certified Public Accountants (AICPA) – the umbrella professional society for all American accountants – noted, “If we are not confronted with a crisis of confidence in the profession, we are at least faced with a serious challenge to our ability to perform a mission of grave public responsibility.”

How to deal with the critical tension inherent in the process of creating accounting rules – a process that relies on private interests acting in the public good – was a key theme in the design of the FASB in the early 1970s. There are several notable
differences between the FASB and its immediate predecessor institution, the Accounting Principles Board (APB). (1) Membership in the FASB is a full-time commitment – members are required to resign all their other positions to serve in the nation’s principal accounting rule-making body; members of the APB served part-time. (2) The FASB is part of an independent, not-for-profit organization, whose trustees are committed in principle to insulate the Board from conflicts of interest; the APB was part of the AICPA. (3) The FASB is supported by an independent full-time research staff to assist in technical and administrative matters; the APB relied considerably on the research support of the AICPA and large auditing firms. ¹⁰

As the differences above suggest, the FASB and its supporting infrastructure were created with the goal of making accounting standard setting more independent of groups with strong vested interests in the rule-making outcomes. But, of course, the challenge still remains that it is in those very groups that the necessary expertise for accounting rule-making lies. The special committee of the AICPA that proposed the establishment of the FASB in 1972 noted, “The common need we see is for a bold new effort to insure public confidence in the ways in which financial information is reported.”¹¹ So the FASB is an experiment of sorts, to extract a select few technical specialists from corporate interests, endow them with independence from those interests, and empower them to set rules. Nearly forty years on, has this experiment delivered on those intentions?

Answering this question requires not simply an evaluation of the FASB, but rather one of the entire ecosystem from which accounting rule-making emerges. This ecosystem includes industrial corporations, financial institutions, audit firms, and, naturally, the FASB members who are drawn from and return to these organizations. A substantial fraction of this book is occupied by a discussion of the results of such an evaluation. Briefly, I find evidence consistent with capture of the accounting rule-making process by a number of these groups.

Making observations about social-welfare implications, including likely capture, of a regulatory institution is extremely difficult. For example, as seen earlier, there is no definitively “correct” accounting method for acquired goodwill, so it is difficult to assert conclusively that the new goodwill method is the result of capture. Rather, the evidence is suggestive. The goodwill anecdote in all its complexity embodies the broader empirical reality. But, relative to other areas where such observations might be made (e.g., the desirability of universal healthcare or a minimum wage), accounting rules are a relatively clean setting. This is because, as discussed shortly, a well-developed economic theory of financial reporting provides a conceptual benchmark of properties of accounting rules against which outcomes of accounting’s political process can be evaluated.
The analysis of the accounting standard-setting process yields insight into a distinct sort of regulatory challenge for the economy – developing essential technical rules of the game in areas where vested interest and substantive expertise are co-located and where the general interest is usually not involved in the political process. In this sense, the analysis in this book is distinct from many other studies of lobbying in widely attended political processes. I call the distinct challenge identified herein the problem of thin political markets. Beyond accounting rule-making, areas such as banking supervision and insurance regulation, standards for auditing and actuaries, and even standards for nuclear power-plant safety are likely thin political markets. Just as accounting rules are at the heart of defining wealth and performance in an economy and are critical to the market system, so too are the rules and standards emerging from other thin political markets.

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The remainder of this introduction is devoted to providing an outline of the chapters that follow. Briefly: Chapter 2 develops a framework for essential properties of accounting rules, given their use in generating metrics for corporate performance evaluation, corporate accountability, and asset allocation. The framework is used in the next three chapters to interpret the evidence on each of three key constituents in the accounting rule-making process: Chapter 3 is focused on corporate managers, Chapter 4 on auditors, and Chapter 5 on the FASB members themselves. Chapter 6 brings to bear some international evidence, discussing the political process of accounting rule-making in two settings outside the United States. Chapter 7 broadens the scope from the creation of accounting rules to the creation of accounting rule-making bodies: it analyzes the recent establishment of a separate U.S. accounting rule-maker for private (unlisted) companies. Chapter 8 consolidates the evidence from the preceding chapters and inductively develops the notion of thin political markets. Chapter 9 begins an exploration of possible solutions to the problem of thin political markets, charting avenues for scholarship and practice.

Chapter 2: Interpreting the evidence on the political process in accounting rule-making requires a conceptual basis of comparison. For example, I began this introduction by reasoning that extant accounting rules for acquired goodwill are likely to compromise corporate managerial accountability in M&A. Strictly speaking, making such an evaluation requires a theoretical benchmark of “optimal” accounting rules. Such a pure theory – which anticipates and predicts all business transactions, their interrelations, their context, and correspondingly their ideal methods of account – is impracticable. But decades of academic research in accounting has specified an economic theory of financial reporting from which the general parameters of a conceptual framework for accounting rules can be drawn. This conceptual framework, introduced in Chapter 2, is used in the
analysis of evidence in subsequent chapters. Much of what I discuss in Chapter 2 will be familiar to readers with a background in accounting scholarship.

The essence of the conceptual framework in Chapter 2 is as follows: Financial reporting is a mechanism facilitating contracting with and the flow of information from the firm. For example, current and prospective shareholders and creditors seek to monitor firm managers, measure managerial performance, and value their (potential) investments. Financial reporting facilitates these objectives. Of course, accounting is not the only information and contracting mechanism – for example, voluntary disclosure by managers to current and prospective shareholders is another potential mechanism. Accounting’s comparative advantages are: (1) its relative verifiability – financial reports are audited; (2) its technology to reconcile flows (profits) and stocks (assets) through double-entry bookkeeping; and (3) its technology to match multi-period investments to corresponding revenues through capitalization. The conceptual framework developed in Chapter 2 is the set of accounting rules that are generally consistent with these properties.

An alternative to the conceptual framework above is the one specified by the FASB itself. Since the late 1970s, the FASB has been developing a set of principles with which it expects its accounting rules to be consistent. These principles have themselves evolved over time, albeit more gradually than the accounting rules. The FASB conceptual framework differs in some significant ways from the framework derived from the economic theory of financial reporting. For example, the FASB framework is largely focused on equity valuation at the expense corporate accountability and performance measurement. Thus, using the FASB framework as the benchmark to interpret the evidence in this book could yield a substantially different analysis. I do not use the FASB framework because it is likely the result of the very political process in accounting that is the focus of this book; its use as a benchmark would constitute a logical circularity.

Chapter 3: Next, I turn to evidence on the role of corporate managers from both industrial and financial companies in the outcome of accounting rule-making. I do so through the case of accounting for goodwill acquired in M&A, which is the focus of Chapter 3. For several years prior to 1999, when the FASB decided to reevaluate M&A accounting rules, the SEC had expressed concerns about those rules. In particular, the SEC was concerned that firms were abusing a particular M&A accounting method called

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b Chapter 2 is based in part on my article “Implications for GAAP from an Analysis of Positive Research in Accounting” published in the Journal of Accounting & Economics, coauthored with Professor SP Kothari of MIT and Professor Doug Skinner of the University of Chicago.

pooling-of-interests in a way that led to overpayment for acquisitions and decreased M&A accountability. When the FASB first proposed a revision to the M&A accounting rules, it considered eliminating the pooling-of-interests method. Such elimination would result in all acquired goodwill being recognized on an acquiring firm’s balance sheet and being expensed annually as amortization. The FASB proposal met substantial opposition from firms using the pooling-of-interests method. For example, Cisco Systems, a habitual pooling-of-interests user, protested that the FASB proposal would “stifle technology development” and “slow job creation.” Soon, Congress got involved, mostly against the FASB proposal. Some members of the House introduced a bill to “impose a moratorium” on the elimination of pooling-of-interests, an almost unprecedented move that inserted Congress into the highly technical world of accounting rules.

During and immediately after the congressional intervention on this issue, a small group of corporate managers, which included those from Cisco, other technology firms involved in M&A, and investment banks, met with the FASB to propose an alternative. If the pooling-of-interests method were to be eliminated, they suggested that goodwill amortization be eliminated as well. Their suggestion was accepted for the most part, resulting in the M&A rules for goodwill impairment we see today. Chapter 3 presents this history with additional formal evidence of the special-interest politics underlying accounting rule-making. Specifically, the members of Congress who became involved in this issue can be linked in statistical tests, through a history of campaign contributions, to corporate interests who were most opposed to the elimination of pooling-of-interests. Further, these corporate interests can be linked to lobbying pressure on the FASB to adopt rules – including elimination of goodwill amortization – that eventually became the official M&A accounting standards.

Earlier, I discussed conceptually the consequences of the elimination of goodwill amortization – potentially decreased accountability in the multi-trillion dollar M&A industry. Chapter 3 augments this discussion with more formal evidence. Specifically, firms with strong indications of failed goodwill from M&A are shown to delay accounting for these losses for more than eight quarters. That is, the timeliness of accounting statements in providing accountability for M&A has declined in some cases by at least two years.

The story of the evolution of goodwill accounting rules is an allegory for the successes of corporate managerial self-interest in accounting rule-making. But corporate managerial interests are mitigated, in theory, by auditors. So an examination of the role of auditors in the process is also necessary. Chapter 4 presents evidence on this matter.

Chapter 4: The auditing industry in the United States (and in many countries worldwide) is an oligopoly. That is, a few large audit firms are responsible for over 95%
of the audits of listed companies in America. And while an oligopoly has persisted in auditing for the entire history of the FASB, the number of players has declined from eight in the 1970s to four today. The tightening audit oligopoly has been a source of concern in public policy circles, with elements of government, the press, and academia worrying that the existing “Big N” audit firms are “too big” or “too few to fail.”

Chapter 4 discusses evidence on how the tightening oligopoly in auditing has shaped the accounting rule-making incentives of the Big N audit firms over the last four decades. As the number of large audit firms has declined from eight to four, the remaining Big N firms have become more concerned about decreased “reliability” in accounting rules. “Reliability” here refers to a key property of accounting rules, which ensures that information is objectively verifiable and, thus, auditable. At first blush, this result could be consistent with increasing aggregate welfare. But additional analysis is necessary before drawing a conclusion: Why would the fewer remaining large audit firms become more concerned about decreased reliability?

Conceptually, auditors face dual incentives in their roles: (1) Catering to clients’ demands on the nature of accounting practices – clients, after all, retain and pay the auditors – which is accomplished in ways that can decrease reliability. (2) Lowering the likelihood of litigation and regulatory penalties that arise from failing their responsibilities to certify client accounting practices, which is accomplished in large part through accounting reliability. As the number of large audit firms decline, the remaining firms can become increasingly secure in their position vis-à-vis regulators and the law – which is the concern inherent in the “too big to fail” argument – and, thus, more likely to cater to their clients’ demands. If true, we would expect to see auditors less concerned about decreased reliability in accounting rules. Alternatively, if, as the number of large audit firms decline, they become more visible targets for political intervention and litigation, they are more likely to emphasize decreased reliability in accounting rules. The empirical evidence is consistent with this latter explanation.

In other words, over the history of the operation of the FASB, as the number of large audit firms has declined from eight to four while their combined market share has remained largely intact, the auditors have focused their lobbying in accounting rule-making to emphasize decreased reliability. But this emphasis comes from motives to protect their own wealth from political and legal scrutiny. One likely consequence of this emphasis is the increasing incidence of accounting rules that are check-the-box or compliance based rather than based on the auditors exercising professional judgment – a phenomenon identified by the SEC as a major source of concern in U.S. capital

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\[d\] Chapter 4 is partly based on my article “The Auditing Oligopoly and Lobbying on Accounting Standards” coauthored with Abigail Allen of HBS and Professor Sugata Roychowdhury of Boston College.
markets. Check-the-box rules not only lower the value-add of auditors in capital markets, they could decrease the overall accountability of the system unless accounting is somehow substituted by an alternative contracting and information mechanism.

**Chapter 5**: With both corporate managers and auditors promoting self-interests in accounting rule-making, focus falls on the members of the FASB itself. After all, as discussed earlier, the institutions and due process of the FASB were set up to increase the independence of accounting rule-makers. Chapter 5 discusses the results of an empirical examination of the accounting rule-making tendencies of every FASB member over its thirty-four year history ending 2006. A number of background characteristics of the FASB members, including their professional experience, their prior employment, and their political tendencies were studied to see if these characteristics predicted the nature of accounting rules they proposed.

Across a battery of empirical tests, one result in particular stands out as statistically robust. Over time, particularly since the 1990s, the proportion of FASB members from the financial-services industry (investment banking and investment management) has increased and this increase is associated with accounting rules that deploy fair-value methodologies.

Fair-value accounting is the practice of measuring assets and liabilities at estimates of their current value in contrast to the centuries-old tradition of keeping books at historical cost. The argument for fair-value rules is that they make accounting more relevant to valuing equity. In this sense, fair-value rules are consistent with the FASB’s emerging conceptual framework. But fair-value rules are also less reliable than their historic-cost counterparts because they involve estimating conjectural profits. Fair-value accounting was blamed for some dubious practices in the period leading up to the Wall Street crash of 1929, and was essentially banned by the SEC from the 1930s through the 1970s. But the use of fair values in accounting rules has increased over the last twenty years as the proportion of FASB members from the financial services industry has increased. There are numerous complex reasons for individuals from the financial-services industry to support fair value accounting. Most notably, accounting profits defined on a fair-value basis rather than a historical-cost basis accelerate the recognition of expected gains, particularly in periods of rising asset prices. To the extent that managerial bonuses are based on such profit numbers, financial services executives reap richer rewards under fair-value rules.

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*Chapter 5 is partly based on my article “Towards an Understanding of the Role of Standard Setters in Standard Setting” published in the Journal of Accounting & Economics, coauthored with Abigail Allen of HBS.*
Thus, the principal result in the study of the impact of FASB members on accounting rule-making is the role of members from the financial services industry in promoting self-serving accounting rules. The growth of financial-services representation on the FASB parallels the financialization of the U.S. economy, and the incentives of finance-sector employees are seen shaping accounting rules at the expense of reliability, a key comparative advantage of accounting.

Chapter 6: Thus far, I have focused on the institution of the FASB and evidence from the United States. But accounting rule-making – like most business activity – has been globalizing. In fact, one of the biggest developments in accounting over the last fifteen years has been the establishment and growth of the International Accounting Standards Board (IASB), the global equivalent (and sometime competitor) to the FASB. Much has been said and written on this issue, which like all globalization efforts is multidimensional and complex.¹⁸ In Chapter 6, I focus on providing evidence for one simple point: that the American experience with the FASB is not unique; special-interest politics has a role in accounting rule-making worldwide.⁷

In 2006, the government of China was in negotiations with the IASB over that country’s adoption of international accounting rules (known as IFRS or International Financial Reporting Standards). A thorny issue arose. IFRS, like its U.S. equivalent, had strict rules on disclosure of transactions between “related parties” (such as firms with substantially overlapping ownership) from corporate financial reports. The notion of disclosing related-party transactions is elementary in and fundamental to accounting: the idea is that transactions between players who are not at arm’s length are not transactions at all. These related-party rules were undesirable to the Chinese government because they could call into question the reported profitability of numerous state-owned enterprises that dominated its economy. State-owned enterprises, by virtue of their common ownership heritage, qualified under the IASB rules as related parties and thus had to disclose numerous transactions in IFRS-compliant financial reports. Chapter 6 describes how the Chinese government was able to water down the definition of related parties in the worldwide accounting rules as a condition to its adoption of IFRS. The IASB obliged, perhaps because having China on board was a major victory in its goal of global accounting harmonization.

Where the Chinese government was able to secure its interests in the global accounting game, the Indian government has had less luck. But even in this case, there is a role for politics in accounting. Chapter 6 additionally documents how a large Indian multinational, Tata Steel, which is part of the Tata Group, one of the country’s largest

¹ Chapter 6 is partly based on my article “The International Politics of IFRS Harmonization” published in the journal Accounting, Economics & Law.
and most respected conglomerates, was able to influence that country’s accounting policy on IFRS adoption in a way that fostered its own interests. Specifically, certain IFRS rules for recording gains and losses due to currency fluctuations (when assets and liabilities are held in multiple jurisdictions) were set aside in India due, in part, to Tata Steel’s lobbying that the rules needlessly hurt its income statement and balance sheet.

Chapter 7: Here I return to the United States to provide a final piece of evidence on the political market for accounting. The issue in this chapter is not simply the creation of an accounting rule that is in the interest of a particular set of corporate managers, auditors, or standard setters. Rather, it is the creation of an entirely new rule-maker itself. On May 23, 2012, the trustees of the FAF, the not-for-profit organization that oversees the FASB, approved the establishment of a new accounting rule-maker, the Private Company Council (PCC). The PCC is charged with producing U.S. GAAP accounting rules for private companies (that is, companies not publicly listed on stock exchanges). Previously, private companies used the same accounting rules as public companies. These were the only “GAAP rules” – produced by the FASB under authority from the SEC, which has a congressional charter to this effect. Although there was no explicit mandate for private companies to use these GAAP rules, private companies did so in part due to GAAP’s widespread familiarity and credibility. Why was the PCC – an institution for separate private-company GAAP – created?

Chapter 7 aims to answer this question by exploring the economic and political forces behind the creation of the first accounting rule-maker in the United States since the FASB was established in 1973. Economically, there are few substantive reasons for separate private-company GAAP. The lone dissenter – also the only research professor – on a special FAF panel to consider the creation of the PCC noted: “There has … been no compelling evidence or framework presented to the Panel to suggest that the objectives of financial reporting differ between private companies and public companies. The Panel has merely been presented with a list of standards that accountants associated with private companies do not find desirable.” Politically, there was a complex coalition behind the creation of the PCC. First, there were the private companies themselves, including large conglomerates such as Koch Industries and private-equity groups such as Bain Capital, who were concerned about the rising costs of complying with FASB rules, particularly since they were not legally obligated to do so. Then, there were industry groups, such as the U.S. Chamber of Commerce, who raised philosophical objections to certain FASB rules around disclosure of corporate information; these rules were motivated by the SEC’s charge of promoting “fairness” in capital markets particularly for small, retail shareholders. Finally, there was the American Institute of Certified Public

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8 Chapter 7 is partly based on the HBS case study “The Private Company Council,” coauthored with Professor Luis Viceira of HBS.
Accountants (AICPA), which was sometimes seen as representing the interests of small auditors over the Big Four. Small auditors had long complained about the dominance of the Big N in accounting rule-making.

The creation of the PCC went unnoticed by most Americans, although its existence can have a significant impact on their future. Rules from the PCC will define the measurement of corporate performance and accountability for private companies, which make up one-half of U.S. gross domestic product (GDP). As with the FASB, this rule-making process is likely to be highly technical and largely outside the public eye. Commercial self-interest is likely to have a defining say in PCC rules. It is too soon to tell whether the creation of separate private-company accounting rule-making will help or hurt aggregate welfare – and to date there is no robust statistical evidence on this matter – but the absence of strong conceptual arguments for creating the PCC does raise concerns about this venture.

Chapter 8: The implications of the various studies discussed in chapters three through seven are explicitly and collectively explored in Chapter 8. Three themes in particular emerge as salient from the evidence discussed in this book. First, corporate accounting rule-making is largely determined by a few specialist individuals (mostly, corporate executives, bankers, and auditors) who enjoy (i) strong subject-matter expertise and experience, (ii) strong economic interests in the outcome, and (iii) little political opposition in the process, particularly from those representing the interests of retail investors and, more so, ordinary citizens (who might be employees, customers, or suppliers of corporations). In other words, corporate-accounting rule-making is a “thin political market.”

Second, the outcome of this thin political market in accounting rules is, in more than one instance, skewed toward the interests of corporate managers, auditors, and bankers in ways that are likely to compromise accounting’s role in corporate performance evaluation, corporate accountability, and investment allocation. Put differently, there is evidence of “capture” of the accounting rule-making process by special interest groups, which could – if persistent in the long run – compromise the functioning and, eventually, the legitimacy of the market capitalist system.

Third, perhaps most importantly, the evidence does not point to systematic and sustained capture by any single special-interest group. That is, investment banks and corporations with strong M&A activity might shape accounting rule-making for M&A; auditors might structure certain accounting rules so that auditing tasks are more check-the-box than judgment-based to mitigate their liability; the financial-services industry

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Chapter 8 and 9 are partly based on my article “Managers and Market Capitalism,” coauthored with Professor Rebecca Henderson of HBS.
might propagate fair-value accounting rules that suit their business model; private companies might seek their own exceptions to rules; but, no one group has an absolute say over the entire process. There is no single extractive organization or institution to take down; no unequivocal villain in the story. The capture in accounting rule-making appears to be narrow and targeted toward the interests of those with the strongest economic incentives in each particular case.

Collectively, these three themes structure a special class of problem in the creation and maintenance of the esoteric market institutions that underlie capitalism. The various actors in the accounting rule-making game are all individually acting in their own interests – seeking to increase their own profits in a manner that is not obviously illegal. Indeed, on one level, their actions, as documented in this book, essentially embody the capitalist spirit; as Milton Friedman famously argued, “The social responsibility of business … is to increase its profits.” Yet, it does not quite add up. The “invisible hand” that aggregates and equilibrates self-interested profit-seeking behavior in markets into a collective prosperity that legitimizes capitalism has not manifested itself in the thin political market that is accounting rule-making. This is so because thin political markets are, by their very nature, one-sided and unrestrained. In this sense, thin political markets are distinct from “thick” political processes where the general public is engaged or where expertise for regulation does not necessarily reside with vested interests.

So, what can we do about this problem?

Chapter 9: I conclude this book with the outline for a solution. But I caution that the solution is by no means intended to be authoritative or exhaustive. Rather, it is presented as a starting point for a conversation about what constitutes appropriate managerial engagement in thin political markets. I have written this book primarily to present persuasive evidence and analysis on the problem of thin political markets; I do not profess to have the dispositive answer.

At the outset, it is important to reiterate that the nature of thin political markets is such that the expertise necessary for appropriate rule-making or regulation lies with corporate interests broadly defined (in the case of accounting rules, “corporate interests” includes auditors and bankers). The notion of a sophisticated independent regulator who can parse out the bias in lobbying information supplied by corporate interests is infeasible because such a regulator will not have access to the necessary field experience to do so. A sophisticated regulator with such field experience is unlikely to be independent of corporate interests, as the empirical evidence on FASB members’ background characteristics demonstrates (Chapter 5). A similar argument applies to any imagined independent third-party expert (e.g., an academic) – such “independence” will likely betray a lack of relevant experience. At best, independent analyses can shed light on the
likelihood of capture, but even such studies (e.g., the analysis in this book) are *ex post facto* and based on a postulated conceptual benchmark. The implication of these observations is that any first-order solution to the problem of thin political markets has to focus on modifying corporate managers’ approach to lobbying.

A skeptical reader might guffaw at this point and assert that it is naïve to imagine a solution that relies on managers “doing the right thing” when it comes to lobbying. While I concede that there is an element of idealism to the solution, a substantial part of Chapter 9 is devoted to considering how such a solution might be practicable. Because, if it is not, the legitimacy of market capitalism is likely to be negatively impacted.

I begin to outline the solution with the observation that in pursuing profit-increasing behavior in the conduct of commerce, managers are acting in the context of the ethical framework that legitimizes capitalism. Without this framework – which lays out the logic for how the individual pursuit of profit aggregates to a collective good – profit-seeking behavior is morally empty. What makes profit-seeking “a social responsibility” (in Milton Friedman’s words) is the very sound reasoning at the heart of capitalism – a reasoning powerfully articulated by Adam Smith and, more recently, by economic Nobelists as ideologically diverse as Kenneth Arrow, Friedrich Hayek, Paul Samuelson, and Amartya Sen. This is not to say that corporate managers are not self-interested, but that the pursuit of such self-interest would not be so overt and unabashed were it not also morally virtuous and ethically sound. After all, many corporate managers, like most everybody else, seek some purpose in their professional lives.

The logic of profit-increasing behavior is the logic of competitive markets; and, as the empirical evidence in this book demonstrates, this logic breaks down in thin political markets. Here, the distinction between thin and thick political markets is also germane. In a thick political market (e.g., the political market for universal healthcare) – with a vibrant deliberative process, diverse views well-represented, and expertise dispersed across interest groups – the profit-seeking approach to lobbying might indeed be ethically tenable. By contrast, the absence of competent opposition in a thin political market obviates the ethical foundations for profit-seeking. In this context, the capitalist spirit of “rent extraction” is no longer virtuous.

When lobbying in a thin political market, corporate managers assume an agency for the market system as whole and, eventually, for the citizens in whose interests market capitalism must function. So, just as there is widespread recognition among managers of their agency to corporations and shareholders – a recognition that is imbued in them via business schools and corporate codes as a moral duty (in addition to being a legal duty; in fact, it is a legal duty because it is moral) – so too we must create a recognition for managerial agency of the system when lobbying in thin political markets.
The natural follow-up question here is, “How?”

For those who are convinced by the evidence of what the status quo in thin political markets has wrought, the temptation is strong to institutionalize a solution – perhaps, by creating new laws to effect and enforce managerial agency of the system; or by creating yet another regulatory body in the hopes that it will somehow be independent of special interests. But such institutionalization misses the point that the problem is at its core an ethical one and, therefore, about individuals and their morality.

I conclude this book with some promising examples of situations where changing managerial norms around lobbying might be positively effecting the functioning of capitalism in society. Of particular note, is the effort of a small group of business leaders who are innovating in the thin political markets of bank governance standards and pharmaceutical drug approval standards with ways to create “ethical spaces” for managers to engage with their regulators. The idea is to set the tone for what is an appropriate “ask” when lobbying, so as to at least narrow the limit of self-interested regulation that might emerge. Both areas are works-in-progress, with attendant limitations, but the ventures offer a pivot for serious and sustainable change in the ethics of managerial lobbying conduct.
8. Political Standards: Lobbying in Thin Political Markets

The book, thus far, has been chiefly concerned with providing evidence on the nature and outcomes of the political process underlying accounting rule-making. But what, if any, are the commonalities across the studies presented? In this chapter, I distill the evidence into a conceptual description of the accounting rule-making process. I argue that the process embodies a peculiar phenomenon of our capitalist system – that of a “thin political market.”

The accounting rule-making process is an esoteric world, ensconced in a shell of specialist knowledge and removed from the eyes of the un schooled public. In this sense, it is largely immune from the dangers of populist policy making (although populism has from time-to-time been effectively wielded as a weapon in shaping rule-making outcomes\(^1\)). But this technical world is not immune to political dynamics, as the preceding chapters have shown. Put differently, in the United States and beyond, across industrial companies, financial institutions, and audit firms, and over both substantive issues and the design of relevant institutions, the corporate accounting rule-making process is at once deeply technical and political.

Those with the knowledge to shape accounting rules – corporate managers, auditors, bankers, and other financial intermediaries – accumulate such knowledge because of their experience and their concentrated economic interests in the outcome of the rule-making process. Conversely, those with dispersed interests – retail investors and the average citizen – rarely enjoy the expertise necessary to engage productively in rule-making; acquiring such expertise is economically unviable given their limited interests. Accordingly, the political process of accounting rule-making is attended by a handful of keen special interests and ignored by the general interest. And, not surprisingly, the outcomes of this process, in several instances, skew toward the special interests and away from conceptual expectations of what accounting rules should look like.

But while a certain special interest might capture the political process in a given instance, there is little evidence of comprehensive capture. On a given issue, those with the strongest incentives and the deepest expertise have the loudest voice and an important say in the outcome. But the portfolio of accounting rules to be determined is broad – spanning all sectors of the economy – and the expertise necessary in each instance is considerable. Thus, a special interest in one area is the general interest in another. Special interest capture is localized; the system itself is not beholden to any one group.
The behavioral model emerging from this description of corporate accounting rule-making is the pursuit of self-interest by participants. This is true of the corporations and investment banks lobbying on M&A and goodwill accounting in Chapter 3; the Big N audit firms protecting themselves from liability in Chapter 4; the investment banking and investment management professionals on the FASB seeking fair-value accounting rules in Chapter 5; the Chinese SOEs and the Indian multinational carving out protections in Chapter 6; and the private-company interests pushing for their own regulator in Chapter 7. Participants from across the spectrum seek to increase their own profits as they engage in the accounting rule-making game. This behavior is entirely consistent with the competitive spirit that underlies capitalism. Indeed, it embodies the moral imperative of competitive strategy, as Milton Friedman and many others have pointed out.²

But capitalism encourages self-interest on the premise of competition; and competition – particularly in a vibrant sense – is uncharacteristic to the accounting rule-making process. Thus, the pursuit of profit, which otherwise engineers markets away from iniquitous amassment of wealth and power toward aggregate prosperity, produces a quilt of special-interest concessions in accounting rule-making. This outcome is what I characterize as “political standards.”

**Prices or Politics?**

Given the evidence on capture of the political process of accounting rule-making, one might credibly ask why accounting rules must be “political” at all? In other words, should accounting rules be regulated? Is the existence of a governmentally sanctioned accounting rule-maker, such as the FASB, necessary to the functioning of market capitalism? Might the issue of capture be avoided altogether if accounting rules were organically determined through economic or “price-based” markets rather than through political markets?

Answering these questions requires a framework for what it takes for price-based markets and for market capitalism, more broadly, to function. A rich history of economic research in this area has identified at least six conditions as essential to the functioning of market capitalism and of market prices therein.³ These conditions are described below. To facilitate exposition, with each condition, I offer examples of how the condition is approximated in practice in the case of U.S. capital markets, which are generally considered well developed.

*Well-defined property rights:* Property rights enable private ownership of assets, which is central to the ability of individuals to engage in voluntary
exchange. Such voluntary exchange is at the heart of capitalism since it allows individuals to allocate their resources in ways that suit their preferences. In a prospective transaction, if a seller’s property rights in the underlying good or service is unclear, the buyer is unlikely to engage in a sale or is likely to demand a significant discount. In the limit, the absence of property rights precludes all market activity. In U.S. capital markets, for example, property rights in financial instruments are usually well defined. They are chiefly established through public institutions such as corporate and securities laws and enforced through federal and state law enforcement agencies as well as private intermediary institutions such as asset-custodial and security firms. Capital markets in several emerging-market nations do not enjoy the level of clarity and enforcement provided under U.S. law, compromising underlying asset prices and, eventually, the markets’ effectiveness in allocating investments across competing ventures.

**Complete knowledge:** For a market to function in a theoretically pure sense, the parties to a voluntary exchange must be acting with full knowledge of the good or service that is being transacted. This means that both the buyer and seller are aware of all humanly known properties of the unit being exchanged, particularly as those properties are relevant to the unit’s value-in-exchange. As a practical matter, this condition is rarely, if ever, likely to be met; but it implies that asymmetry of knowledge between buyers and sellers introduces frictions in markets. The greater the degree of knowledge asymmetry, the less likely the market will function as intended. Numerous institutions in U.S. capital markets mitigate asymmetry of knowledge between suppliers of capital (investors) and users of capital (firms). These include the accounting and auditing industry, financial analysts and ratings agencies, and the financial press.

**Enforceable contracts:** The voluntary exchanges that underlie markets are generally premised on “contracts” that purport to deliver some good or service of value in return for monetary or equivalent consideration. Without these contracts, the exchanges are unlikely to be consummated, particularly if the deliverables-in-exchange are to be made at or over some period of time in the future. Thus, the existence and enforceability of contracts are central to the functioning of most markets. In U.S. capital markets, the legal and accounting industries, together with enforcement through the judicial system, provide the basis for enforceable contracts. Beyond these institutions, numerous other private intermediaries, such as financial insurance providers, are involved in supporting the contracts that underlie capital markets.

**No agency problem:** In a complex society, transactions in markets are executed on behalf of buyers and sellers by their agents. In theory, these agents act in the
interests of their principals. In practice, the agents’ own incentives can cloud their actions so that the exchange price or volume may not reflect the interests of the underlying principals. The more severe the agency problem, the less effectively markets function. In U.S. capital markets, corporate governance institutions play an important role in mitigating the agency problem between suppliers and users of capital, that is, between investors and corporate managers. These corporate governance institutions include boards of directors, investor protection laws such as the law on fiduciary duties, the practice of financial reporting, and the auditing of financial reports.

**Non-collusion:** Related to the condition of “no agency problem” is the condition that the transacting parties in a market exchange are not in collusion with each other. In other words, if a market price is to serve as a reliable indicator of the value-in-exchange of a particular good or service, the exchange must be between two parties at arm’s length of each other. Mitigating collusion in U.S. capital markets is the business of a number of prominent institutions. These include the SEC, federal prosecutors, short sellers, financial analysts, and auditors, all of whom rely in some measure on accounting reports – particularly accounting rules on related-party transactions – to conduct their business.

**Free entry and exit:** Also embedded in the idea of a market is the assumption that players in the market are free to enter and exit as desired. To function, markets and capitalism rely on the continuous emergence of new ventures and the dissolution of old ones. This notion is otherwise popularly referred to as “creative destruction” or “economic Darwinism.” In practice, “entry and exit” in U.S. capital markets manifests through numerous well-known institutions such as: (i) “going public,” where new ventures are launched into public securities markets; (ii) mergers, acquisitions, and divestitures, where publicly listed companies reorganize their ownership base to realize and unleash synergies; and (iii) hostile takeovers, delistings, and bankruptcy, where poorly performing ventures are eliminated from the pool of publicly traded investment options. Corporate accounting reports play a critical role in the functioning of all of these institutions.

As seen from the discussion above, corporate accounting reports are important institutions fulfilling several of the conditions necessary to the functioning of price-based markets and market capitalism. In capital markets alone, corporate accounting reports facilitate the establishment of and contracting on property rights on financial securities; the mitigation of information asymmetries between corporate managers and investors (and relatedly the agency problems and threats of collusion); and the operation of institutions ensuring the entry and exit of publicly listed companies. The standards that govern the production of corporate accounting reports enable the comparability,
consistency, materiality, reliability, and understandability of those reports. Accounting rules are thus central to capital markets.

Beyond capital markets, other markets within a capitalist system are also critically dependent on accounting reports and the rules that govern their production. For example, contracting relationships between a firm and its suppliers and between a firm and its customers are often defined using accounting reports, particularly, if those relationships are intended to be long-lasting or if they span distant geographies or multiple jurisdictions.¹⁷ Further, in several countries (although not in the United States), tax collection by governments from corporations are based on publicly reported accounting statements, so the rules that govern those statements are essential to public revenue.¹⁸

But even if accounting rules are central to capitalism and markets therein, the question still remains whether accounting rules should be regulated – that is, produced by an organization such as the FASB, which, albeit private, has a charter from the SEC. After all, a particularly attractive feature of capitalism is that the profit motive, in many instances, is itself responsible for institutions that sustain the conditions for markets. Put differently, markets make markets work. For example, in U.S. capital markets, a host of intermediary financial institutions – such as accountants, analysts, auditors, commercial and investment bankers, custodial firms, investment managers, lawyers, and ratings agencies – motivated by profit, contribute to the conditions that ensure the functioning of the market between investors and corporations. Can accounting rule-making be similarly generated through the profit motive and subject to competition in price-based markets?

The brief answer is that a fully private price-based market for accounting rule-making is likely infeasible. A number of conditions necessary to sustain such a market cannot be met in practice. In particular, accounting rules are both non-rival and non-excludable in nature. Here, non-rival means that any one group’s use of accounting rules does not preclude use by another. Non-excludable means it is difficult to exclude corporations, accountants, and auditors from using accounting rules once produced. Together, the conditions imply that property rights over accounting rules cannot be reasonably established and that production of these rules cannot be contracted upon in a price-based setting.¹⁹ Thus, accounting rule-making, like several other critical market institutions such as law-making is a “public good.” As such, public goods are more feasibly produced in political markets.²⁰

This is not to say that absent government regulation accounting rules would not exist. Indeed, prior to the establishment of the SEC in the 1930s, companies and their auditors developed rules for preparation of accounting reports on an ad-hoc basis.²¹ Such rules, however, were not generally comparable or consistent. Writing in 1937, prior to the establishment of the first formal accounting rule-making body in the United States, the
then chief accountant of the SEC lamented, “I am very much afraid it is difficult to name many [accounting] principles that are generally accepted.”

Although accounting rule-making is unlikely to be sustainable in a competitive profit-making context, rule-making bodies themselves can be subject to competition, particularly across jurisdictions. Differences in corporate securities laws across states serve as a basis for competition between states for incorporation of business entities, and legal scholars generally view this system as satisfactory. Similarly, differences in accounting rules across jurisdictions could serve as a competitive basis for accounting rule-making bodies worldwide. Such competition would at least provide an external validity check on a jurisdiction’s accounting rules, potentially mitigating the extent of special-interest capture. However, as a practical matter, such competition is unlikely to materialize, particularly since accounting rule-makers across jurisdictions are increasingly harmonizing their activities with each other and with the IASB. The internationalization of accounting has set in place more collusion, rather than competition, in accounting rule-making.

If we accept the conceptual arguments for – and the practical reality of – accounting rule-making as a public good, the best-case scenario would be a benevolent and omniscient regulator who set rules in the broadest public interest – in this case, to facilitate the functioning of markets. Such a scenario is, of course, imaginary. Moreover, as noted earlier, the substantive expertise necessary for the production of accounting rules rests with corporate managers and accountants and their auditors and bankers, so the idea of an “independent” regulator is infeasible in this context.

Thus, we are left with the condition of accounting rules produced through a political process. There remains, then, the issue of how to interpret the evidence on the capture of this process that has been presented thus far. Is the evidence unique? Are there commonalities across other market institutions generated through political processes? The following section addresses these questions.

**The State of Political Markets**

Beyond accounting rule-making, a number of institutions that support the conditions for market capitalism are produced through political processes. In the United States, some of these institutions – such as incorporation laws, bankruptcy laws, securities laws, and corporate disclosure rules – are determined by Congress, its agencies (such as the SEC), or state legislatures and are thus purely public. Others – such as standards for auditing and for the conduct of lawyers, bankers, and actuaries – are determined by professional bodies. This latter class of institutions, like the FASB, would
not exist in their current form without some government support or charter and are thus somewhere in between public and private.

How do corporate interests – broadly defined to include industrial, financial and professional organizations – engage in the political process that creates and sustains at least some of the identifiable conditions for capitalism? A large number of academic studies across numerous disciplines, functions, and geographies have generally yielded a common answer to this question. When contributing to the political process of market-supporting institutions, corporate managers lobby in their own interests, consistent with their profit motive. This usually means lobbying to create conditions that sustain their competitive advantage in markets, even if it is at the expense of the long-term stability and legitimacy of market capitalism.

The bulk of the evidence on this issue comes from studies of the political process of various institutions in the United States, where data on political contributions and lobbying expenditures by managers and corporations are, in a relative sense, widely available. A number of studies have shown a link between corporate political spending and their demands for legislation both from the U.S. Congress and from state legislatures.26 One study examined the relation between campaign contributions from three specialized financial sectors – commercial banking, investment banking, and insurance – and congressional legislation in the 1980s and 1990s to eliminate barriers to operating in the three sectors. The setting allowed for the clear identification of competing interests across the three financial sectors. The study found stable long-term relations between campaign contributions and the profit interests of the financial institutions in proposed legislation.27

Similar results have been obtained in studies of the motives behind corporations when lobbying U.S. regulatory agencies. For example, a study of corporate lobbying of the Federal Communications Commission in 1998 showed that large firms, in particular, are sensitive both to free-riding by industry peers and to the risk of disclosing proprietary information when crafting their lobbying strategies. The evidence suggests firms, motivated by their own interests, employ sophisticated lobbying strategies that dynamically shift between cooperation and individual lobbying as necessary.28 Another study of how audit firms lobby in the determination of auditing standards found systematic relations between the firms’ internal technological capacities and the types of standards they favored. In particular, those firms that relied more on the professional judgment of their staff in conducting audits (and less on formal statistical audit methodologies) were less supportive of attempts to standardize procedures across the auditing profession. Such standardization would likely lessen their advantage in exercising professional judgment.29
Studies of corporate political engagement outside the United States also suggest opportunism as the dominant corporate motive, although inferences from these studies are less persuasive since the international data are coarser. One study looked at over twenty thousand firms across nearly fifty countries and found “widespread” evidence that controlling shareholders and top officers have connections with national parliaments and governments. In this study, politically connected firms represented 7.72% of the world’s stock market capitalization. The announcement of a corporate manager or large shareholder entering politics generated, on average, a statistically significant increase in the firm’s stock-price, particularly for firms in countries perceived as corrupt.30

Beyond the direct political engagement of corporate managers in the political process, there are also studies of their opportunistic shaping of information in political discourse. As discussed earlier, equal access to information is a foundational assumption in the theory of efficient functioning of markets and capitalism. The opportunistic use of information, through strategic disclosure, strategic omission, and spin, can create distortions in the political process, ultimately affecting the functioning of markets. For example, one study found that corporations standing to benefit from proposed import tariffs against competitors opportunistically lower reported accounting profits just prior to political deliberation on those proposals, as if to appear more in need of the tariffs.31

Another study found evidence of corporations managing the information environment around U.S. congressional elections in ways that appear to benefit political candidates with whom they have relationships. Specifically, during the 2004 U.S. general election – where corporate offshoring was a major campaign issue – firms engaged in offshoring opportunistically lowered reported accounting profits when political candidates with whom they had relationships were in close races. Higher levels of reported profits usually bring greater media scrutiny; thus the firms, by understating profits, were likely attempting to deflect media attention from themselves and their preferred candidates.32

The basic tendency of corporate managers to use their wealth and knowledge advantage to lobby for institutions in their own interest is thus widely documented. The idea that profit maximizing individuals will seek to subvert the conditions for markets was identified by Adam Smith even as he developed his theory of capitalism in the Wealth of Nations: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”33

Self-serving corporate political engagement is not in itself a cause for concern. After all, profit seeking behavior is the engine of capitalism. But the condition that makes this statement valid is “competition.” In other words, if the political process is
sufficiently “thick” – in that diverse interests are well-represented and these interests have access to substantive knowledge to shape political outcomes – then a self-serving political engagement strategy by all individuals involved can result in outcomes that advance social welfare. Here, the logical analogy to the functioning of price-based markets is germane. Political competition in this sense refers not just to competing corporate interests – as in the case of the study on commercial banks, investment banks, and insurance firms mentioned earlier – but also to active engagement by labor unions, pensioners, environmental groups, and ideological forums that represent certain normative viewpoints such as organized religion or libertarianism.

For example, the political market for patent regulation in the United States is one that is generally well-represented by diverse, powerful, and (importantly) competing interests, including the pharmaceutical industry lobby, the software industry lobby, lobbies for patients and their families, consumer lobbies, labor-union lobbies, and even church lobbies. Outcomes of this process, although controversial and potentially undesirable to any one group, might in fact represent aggregate social interests. Similarly, the political market for Social Security policy and universal healthcare in the United States is both well publicized and well attended by numerous competing interest groups. In the case of such thick political markets, the ideal model for engagement might in fact be self-interested profit increasing behavior.

In fact, the general consensus from much of the literature on corporate political engagement of the U.S. Congress on broad policy issues is that such engagement is more consistent with “informing” congresspersons about proposed policy than with the “capture” of the policy making process. The evidence suggests that corporations develop long-term relationships with members of Congress in attempts to influence policy; the evidence does not suggest that policy from Congress can simply be bought through large campaign contributions or lavish lobbying expenditures.

How do we reconcile the neutral evidence on corporate political engagement – particularly on widely understood and actively attended policy issues – with the evidence on special interest capture of the accounting rule-making process presented in this book? The answer lies in appreciating that not all political markets are equally liquid and deep. When the policy product is esoteric and the costs to the general interest to remain informed about policy options are high, there is a greater likelihood for special interest capture. The following section focuses on defining a class of “thin political markets” where this is likely the case.

By rigorously defining the notion of thin political markets, we can understand a key logical and ethical limit to the unrestrained deployment of the profit motive by
corporations. The result can be an improved understanding of the functioning of markets and an improved ability to sustain the legitimacy of market capitalism.

**Thin Political Markets**

Why is the process of determining accounting rules a “thin political market”? And how might we be able to identify other thin political markets? In this section, I propose a definition for thin political markets. The definition arises inductively from the evidence and understanding of the phenomenon in accounting rule-making. Like all inductive definitions, it is a first iteration at conceptualizing an issue. I conclude the section with some examples of other potential thin political markets, with the hope that additional research and scholarship into this question might eventually lead us to a sharper characterization of the notion.

A thin political market has at least three distinct but interrelated properties. First, at least one special-interest group experiences concentrated economic opportunity from the outcome of the political process. Here, a special interest group can refer to a company, an industry, a profession, or subgroups thereof. By corollary, there is also a “general interest” in the outcome of the political process. Members of this group have little individual economic interest in the outcome, although the collective economic stake of the general interest can be substantial. The general interest thus suffers from at least a weak form of the collective action problem. I suggest that the collective action problem might not be severe because, depending on the issue at stake, not-for-profit advocacy groups could organize for the general interest (e.g., as consumer-rights groups sometimes do). Alternatively, profit-seeking ventures might be able to purchase and aggregate economic claims from dispersed members of the general interest, creating a sufficient incentive to engage in the political process (as class-action lawyers sometimes do by buying stakes in litigation).

Second, the substantive issue being determined through the political process is sufficiently esoteric that at least one special-interest group enjoys a significant knowledge advantage over the general interest (and, potentially, other special interests). In other words, information that is meaningful to crafting a political solution rests within a special interest, generally by virtue of expertise acquired from its day-to-day functions. Note that this second condition is not simply about an expertise gap between the special interest and everyone else. It is the recognition that such expertise cannot, by definition, exist outside the special interest. For example, crafting accounting rules for M&A requires know-how on the practice of M&A (such as how acquisitions are funded, how assets and liabilities are valued, and how purchase premiums are calculated) and on the accounting and auditing of such practice. This information is not readily known even to an
accounting expert (such as a practicing accountant or an accounting professor) unless that expert is also deeply involved in the practice of M&A.

Third, there is historically little opposition to special interests in the political process, particularly opposition from general interests. This could be for at least two reasons. (A) The cost to the general interest in acquiring the expertise necessary to overcome the knowledge gap described above is practically insurmountable. For example, in the case of M&A accounting, it would require the general interest to assemble to their cause expertise from within investment banks, technology firms, and audit firms. This creates a problem beyond simply organizing collective action. (B) The political process is “professionalized” – that is, implicitly or explicitly organized within the auspices of a professional society or a process that is perceived as being open only to experts. For example, until the creation of the FASB, accounting rule-making was organized under the AICPA, the professional society for accountants. Even under the FASB, public hearings on accounting issues are rarely, if ever, attended by non-accountants or those not closely associated with accounting such as corporate managers, bankers, and business lawyers. This creates a sense of exclusiveness to the process that can dissuade general-interest participation.

Each of these three conditions alone is unlikely to precipitate the one-sidedness of a thin political market. For example, the problem of concentrated economic interests (on its own) can be mitigated through collective action organized via not-for-profits, as discussed earlier. Similarly, a special interest’s knowledge advantage (on its own) could be overcome if other special interests have competing objectives (as in the case of financial-services managers and private-company managers on fair-value accounting). Finally, a political process that is poorly attended by general interests (for example, because it is professionalized) could still mitigate special-interest capture if the relevant expertise is sufficiently heterogeneously distributed. A thin political market is the result of the confluence of all three conditions described above. In fact, I use the term “thin political market” (rather than “thin political process”) because the three conditions that characterize it – the conditions that lead to special interest capture – are analogous, in some sense, to the conditions underlying the definition of price-based markets.

Even with a definition of thin political markets, there remains the question of specifying why these markets lack legitimacy. To be sure, thin political markets can create the conditions for special-interest capture, as several preceding chapters have suggested. But, at least in the case of the institutions of accounting rule-making, particularly the FASB in the United States and the IASB globally, there is no obvious circumvention of due process on the road to capture. Put differently, the concern over the lack of legitimacy in thin political markets stems not from absence of proper procedure, but rather from the outcomes of those procedures properly applied.
Since its inception, the FASB has been committed to a rigorous process for determining accounting rules. This includes deliberating with multiple experts on the items for its agenda, continued consultation with experts before drafting its proposals, openly soliciting comment letters on those proposals from its constituents in a transparent manner, and public votes on final standards by board members. Moreover, since the proliferation of the Internet, the FASB has on numerous occasions made its board meetings and other hearings widely accessible. Its financials are also available for scrutiny and it is overseen by trustees encouraged to act in the public interest. The IASB, which from its beginnings has been modeled after the FASB, has similar traditions of due process, transparency, and accountability, although, as seen in Chapter 6, the global nature of its mission complicates these goals from time to time. In fact, were it not for the meticulous due process and the generous transparency of the FASB and the IASB, the data for the empirical and case studies of accounting’s political process described in this book would not have been available.

The findings in this book suggest that despite all of these safeguards and traditions the political process in accounting rule-making is subject to capture. Thus, the compromised legitimacy of thin political markets is not procedural in nature, rather it is one based on observed post facto outcomes. In particular, the outcomes of the political process are, in some instances, removed from what would be considered optimal or desirable for the functioning of market capitalism.

In the following chapter, which concludes this book, I consider what can be done about the problem of thin political markets. But before transitioning, here I offer some additional candidates for politically derived market institutions that might qualify as thin political markets. I caution that this list is preliminary; I have not studied these institutions in the depth that I have examined accounting rule-making.

Standards for banking regulation and supervision: These include the processes that define key banking metrics such as “Tier 1 capital,” “risk-weighted assets,” and the “capital adequacy ratio,” which are essential timely indicators of the health of banks and the banking sector. Additionally, the processes that determine disclosure rules for banks, including qualitative public and governmental disclosure on banks’ credit risks, liquidity risks, and operating risks. Standards for banking regulation and supervision in the United States are determined by the Treasury Department and the Board of Governors of the Federal Reserve System. Internationally, the standards are negotiated through the Bank of International Settlements in Basel, Switzerland.

Standards for auditing: The rules under which auditors certify the financial statements of companies in the United States are called Generally Accepted
Auditing Standards (GAAS). Until the passage of the Sarbanes-Oxley Act in 2002, GAAS were produced by the Auditing Standards Board, a committee of the AICPA. The Act created a new body – the Public Company Accounting Oversight Board – to produce standards for auditing of publicly listed companies. Standards for audits of private companies continued to be produced by the AICPA committee.44

Standards for governmental accounting: Accounting rules for state and local governments in the United States are produced by the Governmental Accounting Standards Board. In many cases, these rules are different from FASB rules, in part because governments do not use accruals as extensively as corporations. Several studies have provided evidence of local governments manipulating these rules, particularly around elections.

Standards for nuclear power-plant regulation: These rules, produced in the United States by the Nuclear Regulatory Commission, are generally inaccessible to the average citizen due to their highly technical nature. The NRC has been criticized in the past for being too close to the industry it regulates.
Notes

Chapter 1, Introduction


6 For evidence on this point as it applies to goodwill accounting, see Chapter 3. For broad evidence and arguments on the contracting uses of accounting numbers, see Ross L. Watts and Jerold Zimmerman, *Positive Accounting Theory* (Englewood Cliffs, NJ: Prentice-Hall, 1986).


There is an active debate in the academic accounting literature on the objectives of financial reporting. Chapter 2 discusses elements of this debate.


Financial Accounting for Intangibles Reexamination Act, HR 5365, 106th Cong., Congressional Record (October 3, 2000).


For example, in 2007, the SEC organized a committee on “improvements to financial reporting” that was charged with addressing the issue; but the committee’s report was not implemented partly because it was issued in the midst of the commotion that was the 2008 Financial Crisis. Securities and Exchange Commission, “Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission” (PDF file), downloaded from SEC website, http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf, accessed September 7, 2013.


Chapter 8, Political Standards: Lobbying in Thin Political Markets

Populism colored the accounting rule-making debates in the 1990s and 2000s on whether corporate stock-option grants to employees should be treated as an expense in corporate


4 For an overview on the role of property rights in market development, see, for example, Suzanne Scotchmer, *Innovation and Incentives* (Cambridge: MIT Press, 2006).


12 There is a vast literature in accounting, economics, and finance on institutions that mitigate the agency problem in firms, particularly, agency problems between managers and


34 See, for example, Suzanne Scotchmer, Innovation and Incentives (Cambridge: MIT Press, 2006).

35 For a recent history and political economy of Social Security in the United States see, for example, Sylvester J. Schieber and John Shoven, The real deal: The history and future of Social Security (New Haven: Yale University Press, 1999); and Daniel Béland, Social Security: History and politics from the New Deal to the privatization debate (Lawrence, KS: University Press of Kansas, 2005).


See, for example, Martin Cohen and Andrew McKillop, *The Doomsday Machine* (New York: Palgrave, 2012).