



# Regulatory competition for low cost-of-capital accounting rules

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## Abstract

Replacing the current monopoly by multiple accounting rule makers who compete for the allegiance and fees from the reporting firms will help develop better rules and lower cost of capital.

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Paradoxical as it sounds in the current environment dominated by Enron news, the solution to the accounting problems lies in less, not more, regulation.

Under the present arrangements, privately financed Financial Accounting Standards Board writes accounting rules, overseen by the Securities and Exchange Commission, and the Congress. All publicly held firms in US must certify that they conform to this single set of rules.

This monopoly structure for setting US accounting rules has several undesirable consequences.

First, when the FASB proposes new rules to deal with a perceived abuse in the industry, it is subjected to a great deal of pressure not only from segments of the industry but also from the members of the Congress and the Administration. Accounting for restructuring of troubled bank loans, cost of exploration in the oil and gas industry, financial derivatives, employee stock options and mergers and acquisitions are among a long list of examples when FASB's

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attempts to reform accounting rules were frustrated by the industry with political support from Washington.

Second, requests for new rules that the FASB does write often arise from the auditors of public companies when they are hard-pressed by their corporate clients to cite line and verse from the rulebook to back up the audit judgments about questionable accounting practices. After some 30 years of writing, the accounting rules book has grown thick with details to replace managerial and auditor judgment about fairness of financial statements. Instead of writing a rule, which says “thou shalt not steal”, the FASB has wrapped itself up in the endless chase of listing all the acts and circumstances that might constitute “stealing”.

It is a losing game for rule writers. Every rule that covers a new contingency creates new gaps. If you write a rule, “you cannot steal a shirt”, sooner or later someone asks: where does it say you cannot steal shirt buttons? It is for this reason that the Securities and Exchange Commission refuses to define insider trading. Yet, pushed by their paymasters, auditors demand such rules.

Third, FASB’s administrative structure is biased toward supplying such rules. A body whose *raison d’être* is writing rules finds it difficult to say no to requests for clarifications. They must publish new rules each year, and they do.

The SEC could introduce competition to replace FASB’s US monopoly and achieve better rules and financial reports. It could approve two or more sets of accounting rules, say those written by the FASB and the International Accounting Standards Board, and allow companies to prepare their reports according to any one set. Companies would clearly label the reports with the set of standards they conform to.

This would parallel the choices companies make among the 50 states in selecting their corporate charters. Manufacturers of appliances make similar choices in having their products tested and marked by Underwriter’s Laboratories or Good Housekeeping seals. Companies pay a fee to finance the organization whose standards they use.

Regulatory competition will allow individual firms to choose the accounting rules by which they report. The Enron incident may create fears that most firms will “race to the bottom” and choose rules that result in least informative financial reports. On the contrary, vast number of legitimate business firms compete by providing more information in their reports than they have to in their attempts to attract risk-averse shareholders. By choosing more demanding accounting rules, firms can signal their openness and forthrightness to the shareholders. The shareholders would reward such firms by their willingness to accept a lower rate of return on capital in exchange for the lowered risk.

A competitive regulatory regime helps create more efficient rules by feeding information about the stock market consequences back to the makers and users of the rules. No comparative feedback is possible under the current monopoly.

Competition will relieve the lobbying and political pressure on accounting rule makers. Managers unhappy with one set of rules can be asked to choose another. Absence of such pressure will enable some rule makers to distinguish themselves by their “tough” accounting rules. Volunteering to abide by the tough rules is an easy way of conveying a message of confidence to the shareholders.

Competition will also make it easier for at least some accounting rule makers to stick to broad principles, and refuse to write “cook-book” rules that have proliferated during the past three decades. Again, the availability of competition will bring relief from undue pressure from auditors who often demand such rules.

On the supply side, FASB and other rule makers could cut back on their permanent establishments and free themselves from the publish-new-rules-or-perish race. Some rule makers may well choose to adopt flexible organization, assembling resources only when they confront a problem that really needs to be addressed.

A competitive accounting environment will enable the rule makers to use market signals to write cost-of-capital lowering rules, perhaps differentiated by industry and investor clientele.

It will also help corporate managers signal their intent to the shareholders, and the shareholders read that intent with minimum of confusion. Better rules that help investors more clearly differentiate among firms will help reduce, though not eliminate the Enron-type surprises.