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Exploiting regulatory changes for research in management accounting☆

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ABSTRACT

This paper describes recent regulatory changes in the European Union to illustrate opportunities for research in management accounting. Issues are whether a regulation is effective in achieving its objective, how it affects the organizational design and decision making in firms, and what additional data become available. I particularly consider the areas of management compensation, risk management, performance measures, non-financial information, the influence of financial reporting, and accountability.

1. Introduction

I have been invited to share my views on opportunities for future research in management accounting. These views are necessarily subjective and shaped by my own research perspective, which is economics-based. Accordingly, my comments should be read as complementing, rather than substituting, other perspectives. This commentary is not intended to be a survey; I am highly selective in presenting opportunities I find promising and worthwhile exploiting.

The theme I focus this commentary on is motivated by increases in regulation in many areas, including, of course, corporate governance and financial markets. With regulation I broadly mean existing (and sometimes emerging) laws, other legal requirements, standards, and widely recognized guidelines. We have seen cycles in which regulation or deregulation was more prevalent; but during the last one or two decades, we experienced a significant increase in regulation that is relevant for management accounting. This regulation was boosted mainly by financial or economic crises. For example, in the aftermath of the Internet bubble in the early 2000s regulation of corporate governance and transparency made a leap forward; a similar development occurred after the global financial crisis in the late 2000s and further, more current, regulation deals with the consequences of the economic crisis that followed the financial crisis.

Regulatory changes like these provide fertile ground for management accounting research for at least three reasons:

i) The stated objective of a regulatory change is to affect firms and managers, respectively, to motivate desirable behaviors or to discourage behaviors that are considered undesirable. A straightforward (but not at all simple) research question is whether the regulation is effective in achieving its objective, including an assessment of its direct and indirect costs and benefits.
ii) A related research question is how regulation alters the organizational design of firms, i.e., how firms optimally react and adjust or innovate their internal organization, decision-making and operations.
iii) In many cases, new regulation or standards require firms to disclose more information on corporate governance and on their business operations. The availability of such data provides researchers with new opportunities for empirical tests.

At the first glance, it might seem odd that regulation should have a significant effect on management accounting because firms determine their internal organization and management decision processes internally. But as will become apparent, there are many

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regulatory influences that provide constraints to organizational design, incentives, and management accounting procedures.[1]

I use recent regulatory changes in the European Union (EU) as an illustration to explore opportunities for research in management accounting. The EU is one of the largest economies and its legal structure is special in that most of the regulatory action occurs at the country level, although the kick-off often occurs at the EU level. The result is a high level of harmonization across EU countries, but differences on the country level prevail and can be exploited by research.

2. Recent regulatory changes in the European Union

The European Union has been highly active in developing new regulation in the area of corporate governance and financial markets. Most of the major regulatory initiatives were motivated by the desire to harmonize company law and to develop a common financial market within Europe. The early directives in the area of financial accounting and company law attempted to make member countries' legal systems more comparable to foster a common market. In 1999, the Financial Services Action Plan set out a road map to create an integrated financial market; recently, the Green Paper "Building a Capital Markets Union" from 2015 aims at facilitating investment and growth. Other regulatory actions were responses to economic and financial crises.

To achieve its objectives, the EU uses a variety of regulatory instruments: (i) The most common instrument are directives, which require member states to transform the directives into national law, usually within a period of two years after the directive became effective. (ii) Occasionally, the EU enacts regulations that directly apply to companies located in the EU; a prominent example is the IAS Regulation from 2002, requiring listed companies to adopt International Financial Reporting Standards for their consolidated financial statements. (iii) A weaker instrument are recommendations by the European Commission, which are issued if a consensual proposal for a legal instrument is deemed difficult to achieve. Examples are recommendations that restrict compensation of managers of listed companies and for banks and investment companies. Recommendations create awareness in the member states on the particular issue and invite them to take measures to implement the substance of the recommendation. The Commission monitors the implementation through reports by member states, which generates an incentive for governments to apply them. (iv) The European Commission issues Green Papers that include tentative views on particular issues, White Papers that offer more concrete plans, and communications to inform about its plans for future regulatory initiatives.

Besides, and constrained by, these activities on the EU level, member states regulate other areas of corporate governance and financial markets on the national level. Corporate governance is a particular case in which there exists little EU-level regulation. Regulation (in a broad sense) of corporate governance occurs through local law and through corporate governance codes that include comply-or-explain rules. The codes offer companies some flexibility in applying governance principles and combine this flexibility with a transparency requirement rather than strict compliance with a particular rule.[2]

This rich regulatory environment provides a plethora of interesting areas for management accounting research. Before I give examples for specific research questions, I briefly consider different approaches to study such questions.

First, if an issue moves on the agenda of regulatory bodies, this move indicates that the issue is deemed important and, thus, research on it can easily be motivated to be relevant. Research can seek to assess the phenomena that trigger regulatory action and the measures that are discussed in the regulatory domain and those that are finally selected. As outlined above, the process of developing new regulation in the EU occurs in several stages and moves usually relatively slow.

Second, research can study how regulation affects company behavior, including the organization, management, performance measures, and other design choices. Ex ante research includes theoretical research that attempts to understand the likely effects of regulation, not only the direct and intended effects, but also undesirable consequences. Empirical studies at this stage include experimental research and, if existent, archival, field, and case studies from countries or areas that are subject to regulation that is similar to the proposed regulation. In a way, impact assessments required by the EU for proposed legislation attempt to do something similar, albeit usually with less rigorous means than researchers use. Note that the more comparable and uniform institutions become across the world, the less opportunities exist for such ex ante empirical studies.

Ex post research exploits the change in the regulation to study the actual effects on companies and markets. Some regulatory bodies require post-implementation reviews to learn if the regulation achieved its objective and whether it is advisable to adjust the regulation.[3] From an empirical perspective, regulation ideally provides an exogenous shock as a natural experiment that allows identifying and assessing the changes that were caused by the regulation. However, one might question the truly exogenous nature of regulation; for example, many commentators argue that the global financial crisis was triggered by poor corporate governance in financial institutions; and subsequent regulation tried to exactly improve governance. In the absence of a clear exogenous shock, causality is difficult to establish, but the econometric tool set is growing.[4] Typical issues include, for example, the lack of a control group that is not affected by the regulation, but is otherwise comparable to the treatment group. Regulatory changes often occur jointly with changes in other areas or in the economic environment, which makes it hard to attribute any observed changes in behavior to the particular regulation. A practical difficulty is that the regulatory process takes time, and companies use the time to already start adjusting their organization to cope with the anticipated changes. That means there are possible self-selection issues empirical research has to deal with already before a regulation becomes effective.

The EU environment provides several research opportunities. Despite the many efforts to harmonize laws in the member states, differences continue to exist. For example, there is diversity across Europe in several areas of corporate governance, e.g., some countries have one-tier boards while others have two-tier boards, which implies directors have different responsibilities. Moreover, using the Societas Europaea (SE), a European corporation, as their legal form companies can choose between the two governance forms. Of course, just comparing, say, company performance in two countries with different board structures does not provide insights into causal relations because there are many other (and often unobservable) reasons for different performance.

[1] Van der Stede (2011) discusses opportunities and challenges resulting from regulatory reforms as a consequence of the financial crisis. Some of his observations are also reflected in this commentary.

[2] Recently, there seems to be a trend to more regulation by law.

[3] For example, the IASB requires post-implementation reviews of its major new standards as part of its standard-developing process.

[4] Recent work includes, e.g., Gippel et al. (2015) and Gow et al. (2015).