J. Account. Public Policy 35 (2016) 256–275

Contents lists available at ScienceDirect

J. Account. Public Policy

journal homepage: www.elsevier.com/locate/jaccpubpol

Full length article

Price regulation and accounting choice

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A B S T R A C T

This paper empirically investigates the interplay of price regulation on the product market and accounting choices. Specifically, we analyze the impact of regulated prices in the German utility sector on the decision to adopt a new accounting regulation one year in advance of the otherwise mandated adoption. This article finds that regulated firms are more likely than non-regulated firms to adopt the new accounting regulation early, thereby achieving higher regulated revenues. Manually analyzing financial statements, we are able to estimate the increase in firm-specific allowed revenues for the regulation period of 2013–2017. This article contributes to the literature by shedding light on the link of industry-specific product market regulation and managers' accounting choices.

1. Introduction

Accounting systems generally give managers leeway to prepare their financial statements. These accounting choices allow managers to better fit their accounting records to underlying economics. When third parties use accounting information, managers might have incentives to manipulate the accounting numbers in their favour. For example, a well-documented incentive is to reduce tax payments. Other incentives documented by researchers are related to governmental interference or the political costs hypothesis, under which firms seek to bring about favourable regulation or to avoid unfavourable regulation (e.g. Watts and Zimmerman, 1978). So far, little is known about how industry-specific product market regulation can influence the accounting outcome. Thus, this paper

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http://dx.doi.org/10.1016/j.jaccpubpol.2015.12.005
0278-4254/

empirically investigates the effect of product market regulation on accounting choice. In particular, the interest is in the effect of price regulation in the utility sector on the decision to adopt a new accounting regime one year in advance of the otherwise mandated adoption.

We investigate industry-specific regulatory consequences in a European setting. Directive 2003/55/EC[1] of the European Commission requires EU Member States to establish national regulators that fix or approve tariffs in the gas utility market. The main goal of this governmental intervention is to simultaneously ensure low prices and high quality supplies. The most common system used by national regulators to achieve this goal is incentive regulation (e.g. in Belgium, Germany, France, Italy, Spain and the United Kingdom). Incentive regulation refers to price or revenue caps in combination with an efficiency component. The present study is based on the German context because it is possible to use the early adoption of new German GAAP in 2009 as a clearly identifiable and economically relevant accounting choice.

In Germany, revenue caps for the gas utility sector for the regulation period from 2013 to 2017 are based on a financial statement-based audit in 2010. The revenue caps comprise specific operating expenses incurred in 2010 plus a fixed percentage of return on *average* equity (ROAE). The relevant values are based on accounts that are required to be prepared in accordance with German GAAP.

Companies must comply with new German GAAP from 2010 onwards. Thus, the audit to calculate revenue caps for the gas utility sector coincides with the introduction of new German GAAP. The changes in German GAAP introduced new recognition and valuation principles that can affect the calculation of revenue caps. For example, year-end values of the balance sheet items used by the regulator to calculate revenues (e.g. equity) can be affected. Furthermore, early adoption of new German GAAP was allowed for financial years starting in 2009. Companies choosing to adopt new German GAAP one year in advance had the opportunity to influence specific balance sheet items in 2009, which in turn would have an effect on average values for 2010. The present article provides evidence that managers opportunistically chose early adoption so as to increase future regulated prices. First, evidence is presented that firms from the regulated gas utility sector are more likely than other firms to adopt one year in advance. Next, regulatory consequences (increased cash flows) as a result of the early adoption are estimated.

Voluntary adopters of new German GAAP are manually identified using a full-text search in the German Electronic Federal Gazette. This procedure yields a sample of 344 voluntary adopters. There is clear evidence that regulated firms are more likely to adopt new German GAAP early than other companies. By manually analyzing financial statements, it is possible to estimate specific changes that influence revenue caps. These data and the publicly available calculation scheme for revenue caps are used to estimate the effect of early adoption.

The estimated increase in revenues for the five-year regulation period results in inflation-adjusted profits between €626k and €1125k on average. Deflated by book value of equity of 2008, the impact on profits is between 14.2% and 30.5% on average. Additional costs arise from accounting-related efforts regarding the early adoption, i.e. requirements of more detailed disclosures for an additional year.

Furthermore, not all companies in the incentive-regulated gas sector adopted new German GAAP early. For non-adopters, an early adoption of new German GAAP would have allowed less discretion to increase future revenue caps. We conclude that, for these companies, changes in future revenues do not justify the costs of early adoption.

This article contributes to the existing literature by providing a clear link between product market regulation and accounting choice. A stream of literature related to the present study is based on the *governmental intervention argument* asserted by Watts and Zimmerman (1978), under which companies engage in earnings management to obtain favourable regulation (Jones, 1991; Omonuk, 2007) or to avoid non-favourable regulation (Cahan, 1992; Gill-de-Albornoz and Illueca, 2005). These articles show that firms have negative abnormal accruals during periods of heightened political costs, implying that firms seek to reduce excessive returns and thus political visibility.

[1] Directive 2003/55/EC of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC.