An Analysis of Lobbying Behaviour – The Case of UK Deferred Taxation

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Summary

This paper examines the lobbying behaviour of UK managers who commented on Accounting Standard Board proposals to re-introduce full provision deferred taxation accounting. Although there were no direct cash-flow implications associated with these proposals, they had the potential to affect a company's reported net income and revenue reserves. Using published comments and financial statements data, the paper tests: (a) the conventional positive accounting theory gearing hypothesis, using debt/equity ratios and (b) a new dividend hypothesis that is presented in the paper. The findings did not provide support for the gearing hypothesis and are therefore consistent with recent work of various other authors. However, the new dividend hypothesis was supported and the paper therefore suggests that the potential impact that an accounting treatment has on the revenue reserves of a company, and thus its dividend paying capacity, is a plausible reason for observed lobbying behaviour in the UK.

Volume 8 issue (i), March 2006

An Analysis of Managers' Lobbying Behaviour

Introduction

The positive accounting theory (PAT) literature provides a great deal of evidence in support of the hypothesis that senior managers who can influence financial reporting make decisions that serve their personal interests. One might expect that the same motivations would also affect their lobbying positions on accounting standards. This paper outlines a PAT-based hypothesis and tests it using the financial statements of companies whose managers lobbied the Accounting Standards Board (ASB) during the development of Financial Reporting Standard (FRS) 19 'Deferred Tax'. Section 2 of this paper identifies some PAT literature that discusses why managers might lobby on certain accounting standards. The debt/equity hypotheses derived from this literature is supplemented with a new hypothesis based on the argument that managers would choose to lobby for or against a proposed standard depending on its impact on the dividend paying capacity of the firm. Section 3 outlines the different accounting treatments possible when accounting for deferred tax, while section 4 describes the data and research method. Section 5 discusses the results and section 6 offers some conclusions.

Managers' Motivations for Lobbying

The reasons why managers who can influence the selection of a firm's accounting procedures prefer certain accounting treatments to others has been a topic of interest for many years (e.g. Gordon, 1964). Watts and Zimmerman (1978) suggested that it is important to be aware of managers' motivations because managers contribute to the determination of accounting standards. They can do this by various means, including lobbying the standard setting body in the early stages of the standard's development. These authors hypothesised that '…management would lobby on

accounting standards based on its own self interest…' and sought to establish how accounting standards affected the wealth of company executives (Watts and Zimmerman, 1978). Later work in PAT (e.g. Watts and Zimmerman, 1986) identified management compensation plans, debt-covenant restrictions, share value and political costs as being likely to influence the accounting treatments adopted by management. Since 1978, PAT has been both criticised (Christenson, 1983; Williams, 1989; Sterling, 1990; and Chambers, 1993) and defended (Watts and Zimmerman, 1990 and Hall, 1997) in the academic literature. Deegan (1997) provides an overview of these criticisms but concludes that, despite some limitations, it is now viewed as a useful theory that is widely accepted in the academic community [1]. Neu (1997) arrives at similar conclusions. Further tests of hypotheses drawn from the general theory are therefore of interest. Accounting numbers are an important feature of many contracts within firms and can therefore affect the economic interest of individuals involved with those businesses (Jensen and Meckling, 1976; Smith and Warner, 1979; Healy, 1985; Watts and Zimmerman, 1986; Fields *et al*, 2001). Consequently, one can reason that such individuals will prefer accounting measures that maximise either their personal wealth or that of their organisation. Empirical research testing this theory commonly uses management compensation plans and debt contracts as explanatory factors for accounting decision choices, because accounting numbers influence these contracts and it is usually possible to collect data relating to these variables from published documents or readily available databases (Watts and Zimmerman, 1986; Fields *et al*., 2001). Insufficient information is available regarding the companies that commented on FRS 19 to

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[1] Deegan (1997) argues that the acceptance of PAT is evidenced by two observations. First, PAT is widely taught in most undergraduate courses, particularly in Australia. Secondly, two of the top US journals, Journal of Accounting and Economics and Journal of Accounting Research, publish much PAT based research.

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allow an analysis of their compensation plans. This paper therefore does not consider the compensation plan hypothesis.

The Debt/equity Hypothesis

Debt contracts often employ accounting numbers to constrain management actions (Smith and Warner, 1979) [2]. For example, these authors observed that 90.8% of their sample used accounting numbers to limit the issuance of additional debt, 23% to restrict dividend payments, 39.1% to limit merger activity and 35.6% to control the sale of assets. Fields *et al*., (2001), claim that the contractual use of accounting information has become a widely researched topic and summarise the results of research conducted in the 1990's. The use of debt contracts in this area of research is diverse and includes: the debt covenant as a ratio of funds available for dividends to dividends paid (Healy and Palepu, 1990); companies that defaulted by violating debt covenants as a method of sample selection (Sweeny, 1994; DeAngelo *et al*., 1994; DeFond and Jiambalvo, 1994); the economic impact of an accounting choice on debt covenant constraints (Haw *et al*., 1991); an examination of lending contracts to establish the use of GAAP and non-GAAP accounting methods (Chung *et al*., 1993) and; an analysis of the costs of covenant violation versus those of compliance (Francis, 1990). In relation to whether accounting choices are influenced by debt covenant concerns, Fields *et al*. (2001) suggest that the evidence is inconclusive, but that there is a significant amount of data to suggest that accounting choice is influenced by the potential violation of debt covenants.

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[2] Day and Taylor (1996) examine the economic role of covenants in debt contracts in the banking industry and conclude that their purpose is more diverse than merely restricting the discretion of managers. Other functions included the provision of (a) a broad framework of control, (b) an early warning signal of potential problems (c) powerful levers to be used during debt renegotiations and (d) the means to call the loan.

Infringement of debt related constraints may result in the enforcement of any pre-agreed remedies such as damages or the appointment of a receiver, which could adversely affect the future welfare of managers. The resulting re-organisations and loss of reputation can greatly reduce managers' future employment prospects and remuneration (Gilson, 1989). Increases in current reported profit have the potential to reduce the likelihood of such infringements because they reduce debt/equity ratios, increase dividend cover and usually increase the book value of net assets. Conversely, the reduction in current reported profit increases the likelihood of such infringements. Consequently, one can hypothesise that managers will seek increases and resist decreases in reported profit as their firms approach the imposition of debt related constraints. Much of the early work on the influence of debt contracts on accounting choices used relatively high debt/equity ratios as proxies for the likelihood that restrictive covenants might be enforced. Duke and Hunt (1990) concluded that, although such ratios are good proxies for the closeness to some covenant violations, they are not satisfactory for all covenants. Nevertheless, the ratio is readily observable from published information and, in the absence of available alternatives, is widely used in empirical investigations (Fields *et al*., 2001). This paper also uses debt/equity ratios as proxies for the likely imposition of constraints. The resulting debt/equity hypothesis states that the larger a firm's debt/equity ratio, the more likely the firm's manager is to select accounting procedures that shift reported earnings from future periods to the current period and avoid procedures that remove such earnings from the current to future periods [3].

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[3] According to Watts and Zimmerman (1986), such a hypothesis is derived from the argument that the closer a firm is to a restrictive accounting based covenant, the more likely the manager is to use procedures that increase current earnings.

The Dividend Hypothesis

Interestingly, there is no established hypothesis in the PAT literature relating to dividends. That may be because most of the literature emanates from the USA where there does not appear to be a widely applicable legally enforceable regulation that limits dividends by reference to revenue reserves. In contrast, Section 264 of the UK Companies Act 1985 uses accounting numbers to constrain a company's ability to pay dividends, by stipulating that dividends can only be paid out of realised profits. Such a stipulation means that accounting policies that reduce current revenue reserves may adversely affect a firm's ability to pay a future dividend. In perfect markets, such an outcome should be irrelevant to equity holders (Miller and Modigliani, 1961). However, this conclusion cannot necessarily be extended to imperfect markets. In practice, capital market transactions involve costs, which may encourage equity investors to favour companies with stable dividend policies. Such policies can enable them to achieve their preferred patterns of consumption over time while avoiding the costs that would arise from any sale or purchase of shares otherwise required. This implies that rational investors should consider a company's dividend policy before investing in it. Arguably, people who seek capital gains will invest in low dividend payout firms while those who seek cash income will invest in high dividend payout companies (Miller, 1977, Long, 1978, Copeland and Western, 1988). In both cases, the cash costs involved in satisfying preferences for current or future cash by frequent trading on the capital markets would be avoided. Senior managers of firms may be aware of this "clientele" effect and may therefore wish to avoid frequent changes in dividend policy. Overall, one can interpret the clientele hypothesis as suggesting that many businesses will try to avoid changes in dividend policy and any reduction in the annual dividends paid.

There is usually an asymmetry of information between investors and insiders (e.g. senior managers) of firms listed on the stock market and dividend policy may be seen by shareholders as an indication of future profitability. Such a possibility seems reasonable if existing empirical evidence is considered. Lintner (1956) suggested that most companies seek to follow a smoothed dividend policy – only increasing dividends if they expect to be able to maintain them in the future. This expectation was supported by a survey of 179 UK finance directors conducted by 3i (1993), in which over 90% of respondents agreed that dividend policy should follow the long-term trend in earnings. A survey of US investors (Baker, Farrelly and Edelman, 1985) revealed similar preferences. We are not aware of any evidence that suggests that these opinions have changed or of any reasons that might motivate managers to change their opinions. These perceptions, coupled with information asymmetry, imply that investors may reasonably consider that changes in dividend levels frequently provide information about expected changes in long-term earnings and therefore have consequences for share prices. This view is commonly referred to as the "information content" hypothesis of dividends (Aharony, Falk and Swary, 1988; Lonie, Abeyratna, Power and Sinclair, 1996; Gunasekarage and Power, 2002). Acceptance of that hypothesis could be expected to lead rational managers to prefer accounting practices that allow them to maintain or increase their dividend paying capacity.

Acceptance of the "clientele" and "information content" hypotheses suggests that managers would usually be reluctant to reduce dividends. In a positive accounting context, this argument can be translated to a hypothesis that managers will seek to employ accounting policies that maintain their firm's dividend paying capacity and resist policies that reduce their dividend paying capability. As noted above, this capacity is legally

constrained in the UK by the size of existing reserves relative to dividends. Consequently, the higher the ratio of reserves to dividends, the greater the likelihood that firms can maintain or increase dividends in the future. It is, then, possible to hypothesise in the context of lobbying that: "Managers will lobby against proposals that materially reduce their ability to pay dividends". This is hereafter called the dividend hypothesis.

Given the above constraints imposed by UK laws, a possible empirical measure of the impact of accounting proposals on the ability to maintain dividend payments is the expected reduction in revenue reserves following the change of an accounting policy as a percentage of pre-change reserves. This ratio provides an indication of the extent of the potential reduction in reserves available for the maintenance of dividends in the event of future adverse trading conditions. As indicated above, the level of dividends relative to reserves may often matter when determining the possible effects of a specified decline in reserves. For example, a reduction in reserves of 25% will be more important in reducing flexibility in the payment of future dividends if the firm involved has a ratio of reserves to dividends of 2 than if it had a ratio of 10. That suggests that the empirical measure of a percentage reduction in reserves is likely to be only a crude proxy for the impact of accounting changes on dividend paying capacity. Arguably further (possibly alternative) measures could provide a more refined analysis that is more likely to show statistically significant results [4]. Unfortunately, the data required to use those measures was not available to the researchers. This paper therefore uses the crude proxy of percentage reduction in reserves, recognising that it may be less likely to reveal any underlying association between reduction in dividend paying capacity and

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[4] For example the percentage reduction in dividend cover.

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lobbying behaviour. That in turn implies that weaker levels of statistically significant associations are likely to be observed, using the crude proxy, than might be observed using more refined measures. It follows that any significant observations reported in this paper are not invalidated by failure to include dividends in the definition of the independent variable representing reduction in the dividend paying capacity of the firms.

In the context of lobbying, the discussion in this section suggests the following hypotheses:

> $H_{1e:}$ Debt/Equity hypothesis:- "the higher a firm's debt/equity ratio, the more likely it is that its managers will lobby against a proposal that shifts reported earnings to the future from the current period."

> $H_{2e:}$ Dividend hypothesis:- "the greater the proportionate reduction in a UK firm's revenue reserves arising from a proposal, the more likely it is that its managers will lobby against that proposal."

Accounting for deferred tax

This paper tests the above hypotheses using data based on managers' lobbying on a proposed standard for accounting for deferred taxation. Hope and Briggs (1982) recognised deferred tax as a contentious issue and observed that it appeared on the Accounting Standards Committee's (ASC) original list of topics for future consideration as early as 1969. Historically, three possible methods of accounting for deferred taxation have been

debated in the UK: the nil provision/ flow-through method (NP) [5], the partial provision method (PP) [6] and the full provision method (FP) [7]. Table 1 depicts the chronological development of accounting for deferred taxation in the UK, which appears to have come full circle.

Exposure Draft (ED) 11 (ASC, 1973) first required FP. Gradually, support for PP gathered momentum until ED 33 (ASC, 1983) required its use. A revised Statement of Standard Accounting Practice (SSAP) 15 (ASC, 1985) confirmed this approach until the issue of the Urgent Issues Task Force (UITF) Abstract 6 (ASB, 1992). That Abstract permitted deferred taxation in relation to post retirement benefits to be accounted for using FP, yet required deferred tax on all other items to be accounted for using PP. Apparently it re-ignited the debate on deferred taxation and arguably resulted in the issue of Financial Reporting Standard (FRS) 19 'Deferred Tax' (ASB, 2000) which again required the use of FP [8]. It is obvious that UK accounting standards for deferred taxation have, over time, required different and mutually incompatible approaches to measurement. One can anticipate that each approach has a different proportional impact on the earnings and reserves of different firms. Consequently one

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[5] The nil provision method requires both the tax charge in the profit and loss account and the tax liability in the balance sheet to reflect the amount of tax currently payable based on the profits of the current financial year (ASB, 1995).

[6] The partial provision method of accounting for deferred tax reflects the amount that management considers will be payable/recoverable (ASB, 1995). Thus the calculation of the deferred tax liability involves the estimation of (and non-provision for) any timing differences that are likely to be replaced by future tax allowances on future capital expenditure.

[7] The full provision method provides for all timing differences regardless of whether or not they are likely to reverse in the future (Wilson et al. 2001).

[8] The new accounting standard differs from the traditional understanding of full provision in that it permits the deferred tax balance to be discounted. It also differs from the equivalent international accounting standard, IAS 12, in this, and several other respects.

Table 1 Chronological Development of Accounting for Deferred Tax from 1973

May 1973	ED11	Accounting for Deferred Taxation - full provision - deferral method
August 1975	SSAP 11	Accounting for Deferred Taxation - full provision - either deferral or liability method
October 1976	SSAP 11 (suspended)	Accounting for Deferred Taxation - withdrawn October 1978
May 1977	*ED 19*	Accounting for Deferred Taxation - partial provision method first mooted but full provision method still required - liability method
October 1978	SSAP 15	Accounting for Deferred Taxation - full provision unless certain criteria could be met. If criteria met, partial provision could be used.
June 1983	ED 33	Accounting for Deferred Taxation (proposed amendments to SSAP 15) - partial provision method to be seen as the norm, but full provision permitted if justified.
May 1985	SSAP 15 (Revised)	Accounting for Deferred Taxation (revised) - move to partial provision in line with ED 33 - liability method only
December 1992	SSAP 15 amended due to UITF 6	Accounting for Post-Retirement Benefits - permitted deferred tax on post retirement benefits to be accounted for using the full provision method, even though deferred tax on all other timing differences was to continue to be accounted for using the partial provision method.
March 1995	Discussion paper	Accounting for Tax - proposed return to the full provision method.
August 1999	FRED 19	Deferred Taxation - Confirmation of the full provision method with possible discounting of the resulting deferred tax liability
December 2000	FRS 19	Deferred Taxation - Full provision with choice of discounting

Source: Davies, Paterson and Wilson (1999) and Weetman (1992)

might expect that managers will have different levels of motivation to lobby for their preferred approaches.

Although each of the three identified methods of accounting for deferred tax can result in materially different accounting numbers in the income statement and balance sheet, there are no direct cash consequences. Where a company anticipates continuing future investment in fixed assets, the deferred tax provision required under the full provision method is likely to be greater than that required under either the partial provision or the nil provision method. Curtis, Davies, Richards and McIntyre (2001) suggest that, in the majority of cases, the requirement to change from the partial provision method to the full provision method will result in a prior year adjustment. That adjustment is likely to have the effect of increasing the deferred tax provision whilst decreasing the profit and loss account reserve (ibid.). Brown (1999) argues that the change would be most marked for capital intensive industries [9]. This paper proceeds under the assumption that the adoption of FP will reduce revenue reserves and therefore the debt/ equity ratio and 'accumulated realised profits'. As the Companies Act 1985 uses 'accumulated realised profits' to calculate distributable profit, adoption of FP could affect dividend distributions. That assumption allows the following versions of the above hypotheses to be empirically tested:

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[9] This is because under partial provision capital intensive companies were likely to have large tax allowances for capital expenditure in advance of depreciation charges in the profit and loss account, which then created a correspondingly large deferred tax liability under FP. A company which is less capital intensive is likely to have a proportionally smaller balance of advance capital allowances and therefore a correspondingly smaller deferred tax liability. Based on SSAP 15, companies would have provided for only a proportion of the deferred tax liability that would arise under the FP method. It therefore follows that capital intensive companies would usually have larger balances of unprovided deferred tax on adoption of FP and would therefore experience larger decreases in their reserves than less capital intensive companies.

$H_{1e:}$ Debt/Equity hypothesis:- "the higher a firm's debt/equity ratio, the more likely it is that its managers will lobby against FP."

$H_{2e:}$ Dividend hypothesis:- "the greater the proportionate reduction in a UK firm's revenue reserves arising from the adoption of FP, the more likely it is that its managers will lobby against that method."

Georgiou and Roberts (2004) also model corporate lobbying behaviour with respect to the ASB's 1995 discussion paper. However they expand the definition of lobbying and explore the behaviour of three groups of companies: those that did not lobby; those that lobbied in favour; and, those that lobbied against the proposals. They combined observations drawn from published comments to the ASB with data from a survey. Consequently, they derived a sample of a large population; whereas this paper analyses the population of firms that lobbied and had their comments published. These firms represented a complete subset of the wider population. Consequently, the paper by Georgiou and Roberts (2004) is not directly comparable to the present one. It is, however, interesting that they suggest that those companies who lobbied against FP were more likely to have debt covenants than those that lobbied in favour, although debt covenants did not adequately explain the difference between lobbyists and non-lobbyists.

Data and Method

Written responses to ASB pronouncements provide publicly available evidence of lobbying by interested parties. Therefore, copies of the responses to (a) the ASB's 1995 discussion paper

(ASB, 1995) and (b) Financial Reporting Exposure Draft (FRED 19) (ASB, 1999) were obtained to analyse how managers lobbied during the development of FRS 19 (ASB, 2000). There were 143 respondents to the ASB's 1995 discussion paper, 93 of which were classified as 'industry (corporate respondents)'. The majority of these respondents worked in firms listed on the UK Stock Exchange, 34 of which featured in the UK FT100 [10]. There were 100 respondents to FRED 19 of which 51 were corporate. The submissions of the corporate respondents to both documents were isolated and categorised by reference to their support for or against FP. The respondents' preferred method of accounting for deferred tax was categorised as either: the nil provision/ flow-through method (NP), the partial provision method (PP) or the full provision method (FP). Where respondents supported NP or PP, or criticised FP (even though they expressed no preferred option) they were deemed to have been in opposition to the ASB's proposals. Table 2 shows an analysis of the corporate responses to both the 1995 discussion paper, FRED 19 and overall.

Table 2 Analysis of the Corporate Responses to the ASB 1995 Discussion Paper and (FRED) 19

	ASB 1995 Discussion Paper	**FRED 19 (1999)**	**Combined Adjusted Total**
Column **Lobbying Position**	**(a)**	**(b)**	**(c)**
Against FP	73 (78%)	29 (57%)	89 (73%)
For FP	20 (22%)	22 (43%)	33 (27%)
Total	93	51	122

Note: The combined adjusted totals (column (c)) are obtained after adding the two sets of responses together and adjusting for several companies who responded to both the 1995 discussion paper and Fred 19 (1999). Of these

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[10] It is not known how many of the remaining 66 FT 100 firms submitted comments because it is possible to ask that comments are not placed on public record. As indicated below, this means that we can only partly test the participation of commentators.

companies, 10 maintained the same lobbying position, whilst 6 changed their position. The lobbying positions of the former group were taken into account in the 1995 responses only, having been eliminated from the 1999 responses. The lobbying positions of the latter group were eliminated from both the 1995 and 1999 responses. These adjustments reduced the 1995 responses by 6 and the 1999 responses by 16 resulting in an adjusted total of 122.

An analysis of Table 2 reveals that, in 1995 (column (a)), 73 (78%) of the corporate respondents lobbied against FP while 20 (22%) lobbied for the proposed method. The corresponding figures for FRED 19 (1999) (column (b)) were 29 (57%) and 22 (43%) respectively. These figures were combined and adjusted for 16 respondents who lobbied on both occasions in accordance with the note in Table 2. The combined adjusted results (column (c)) indicate that overall 89 (73%) were against and 33 (27%) were in favour of the FP approach. Using the combined adjusted total data and a confidence level of 99%, we can conclude that between 60% and 83% of managers would lobby against FP. Given that this range of percentages does not include 50% we suggest that the majority of the population of managers would be likely to lobby against the FP approach.

Table 2 shows a large decrease in the number of corporate responses between 1995 (93) and 1999 (51). Furthermore, although 78% of respondents were against FP in 1995 only 57% opposed it in 1999. Despite the initial opposition to FP in 1995, FRED 19 (1999) continued to advocate FP, albeit with the concession of discounting. Georgiou (2002) examined the factors which influenced the decisions of a sample of UK listed companies not to make submissions on the ASB's 1995 discussion paper on Deferred Tax. He found that those factors included a perception that lobbying in the standard setting process would make little difference to the outcome. Of the original 93 companies that responded to the ASB in 1995, only 16

resubmitted a comment letter in 1999. It is possible that the 77 companies that chose not to resubmit a comment letter considered their views to have been rejected by the ASB. If that was the case, there would appear to be little incentive for them to resubmit the same comments in 1999. There are, therefore, a number reasons that could explain the decrease in response rate between 1995 and 1999. It is also interesting to observe that only 6 firms of the 16 that re-submitted, representing 6% of the original 93 firms in 1995, changed their lobbying positions in 1999. Given their changed positions, there were obviously incentives for those firms to correct the previous record.

The following analysis attempts to relate managers lobbying positions to accounting variables. Inherent in that process is an implicit assumption that the accounting variables used are uniform in all firms considered (so that comparisons between firms are valid on the basis of the variable used). Obviously this assumption is not generally valid, but is widely accepted in the statistical empirical work in the area. Even so, one can reason that comparisons are more valid when made in respect of the same time period than if made between different periods that may have been subjected to different economic environments. That suggests that consideration of a combination of the accounting data from the 1995 and 1999 respondents would not have been appropriate. The analyses relating to H_{1e} and H_{2e} therefore uses accounting data of the 1995 respondents only, as that provides the largest single sample of data.

H_{1e} expresses a general expectation that management of firms with relatively high debt/equity ratios will be more likely to resist a proposed move to implement income decreasing accounting proposals. In the context of a proposed move to FP, the hypothesis suggests that the larger a firm's debt/equity ratio the

more likely the firm's manager is to lobby against a suggested adoption of the FP method. An appropriate null hypothesis H_{1e} is therefore: "the size of the debt/equity ratio is not associated with the tendency to lobby against FP". The financial statements of the 93 corporate respondents to the 1995 discussion paper were obtained and the debt/equity ratio (GER) was calculated using the accounting numbers in the published financial statements.

Duke and Hunt (1990) investigated the use of seven versions of the debt/equity ratio as a proxy for the tightness of restrictive debt covenants. They found that all seven were positively related to the existence and tightness of retained earnings restrictions. Furthermore, their results were not sensitive to the definition of the debt/equity ratio employed, which suggests that researchers can have some confidence in using any of the versions investigated in their paper. The research underlying this paper used two versions of the debt/equity ratio in its empirical analysis: total debt/shareholders' funds and long-term debt/shareholders' funds. It was recognised that the deferred tax liability might, or in some cases might not, be considered to be debt. Therefore, each of the above ratios was calculated both with and without the deferred tax liability in the debt measure, resulting in the examination of four debt/equity ratios in total [11]. Of the 93 corporate respondents to the 1995 discussion paper, 10 were excluded from the analysis because it was not possible to obtain sufficient information for them [12]. A further two companies were

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[11] Ratios are not the only proxy that can be used to measure debt/equity, for example Georgiou and Roberts (2004) based their analysis on the calculation of a self-developed debt equity index.

[12] This was due to a variety of reasons, including the following: one company was a private limited company and refused to supply a copy of its annual reports, one company had ceased to trade, five companies had merged with other companies, and the annual report of three companies were presented in the currency of the holding company (for example US $).

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also eliminated as outliers, leaving 81 companies (see Table 3). The 12 firms in the finance industry were also eliminated from the data set due to the problems associated with the calculation of their debt/equity ratio, reducing the number of observations from 81 to 69 companies (see Table 3). The resulting reduction in the size of the population, although unavoidable, reduced the likelihood of observing statistically significant observations. Logistic regression was then used to test H_{1e} by examining the level of association between a high debt/equity ratio and the logistic transformed probability of a resistance to FP. Specifically, binary logistic regression was used to classify the observations into one of two categories: 0 (lobby for FP) and 1 (lobby against FP). As indicated above, it is hypothesised that any linear relationship between the debt/equity ratio and the likelihood of lobbying against FP would be positive. The generalised linear model of the probability that an observation falls into category 0, (p) takes the form:

$$\text{Logit (p)} = C_0 + C_1X_1 + C_2X_2 \ldots + C_nX_n \qquad [1]$$

Where

$$\text{Logit (p)} = \text{Ln}\{p/(1-p)\} \qquad [2]$$

and Ln denotes natural logarithm. The terms $X_1 \ldots X_n$ are the independent variables thought to explain why a firm might choose to lobby for the full provision method. Consequently, it can be shown that:

$$p = 1/\{1+\exp(-[C_0 + C_1X_1 + C_2X_2 \ldots + C_nX_n)\} \qquad [3]$$

To test H_{1e}, equation [4] (model 1 in Table 4) was estimated:

$$\text{Logit (p)} = C_0 + C_1(\text{GER}) + C_2(\text{SIZE}) \qquad [4]$$

where GER is a measure of the debt /equity ratio. Holthausen and Leftwich (1983) found that size and leverage were the only two significant variables explaining choices of accounting techniques in their review of 14 papers (Fields *et al*., 2001). Therefore net assets (SIZE) is included as a control variable in the equation.

H_{2e} expresses a general expectation that the greater the proportionate reduction in a firm's dividend paying capacity arising from a proposal, the more likely it is that management will lobby against that proposal. In the UK, determination of a company's dividend paying capacity is made by reference to the distributable profits at the single company level and consolidated accounts are irrelevant for such purposes. Of the original 93 corporate respondents to the 1995 discussion paper, 89 formed part of a group and consequently produced consolidated accounts and the balance sheet of the parent company only. Of these groups, 60 were set up in such a way that the parent held very few assets, other than the investment in subsidiaries, and therefore there was no unprovided deferred tax in the parent company. Given the small remaining sample, a direct test of any correlation between management lobbying and a potential reduction in revenue reserves resulting from the ASB deferred tax proposals at the single company level was not therefore sensible. Nevertheless, although consolidated reserves are not used directly in the determination of distributable profits, they give some indication of the dividend paying capacity of the group as a whole. They therefore provide a possible, albeit crude, measure of overall reductions in that capacity once unprovided deferred tax has been adjusted for and are used here for that purpose. Again any failures of the proxy measure to adequately reflect the underlying reality will reduce the likelihood of observing significant relationships. H_{2e} suggests that the larger the decrease in a UK firm's revenue reserve, the more likely the firm's

managers are to lobby against the suggested move to FP. An appropriate null hypothesis is therefore: "the size of the likely percentage decrease in revenue reserves is not associated with the tendency to lobby against FP". Again, lobbying positions are represented by 0 (lobby for FP) and 1 (lobby against FP). It is anticipated that any linear relationship between a reduction in reserves and the likelihood of lobbying against FP would be positive. To test H_{2e}, the finance companies were reincorporated into the sample increasing the 1995 data set to 81 companies. Statement of Standard Accounting Practice (SSAP) 15 (ASB, 1978) required the amount of unprovided deferred tax to be disclosed in the notes to the accounts. This information was extracted from the notes to the accounts of all 81 firms and expressed as a percentage of the profit and loss account reserve, the UPDR percentage. (A UPDR percentage of 25% signifies that the unprovided deferred tax constitutes a potential reduction of 25% of revenue reserves.) Of the 81 'industry (corporate respondents)' tested, 19 respondents worked in firms that would be unaffected by the ASB's proposals, because they already accounted for deferred tax on the full provision basis and therefore had no unprovided deferred tax. A further 10 companies required a deferred tax asset to be created. Consequently only 52 of the 81 companies would suffer an unprovided deferred tax liability adjustment on the adoption of FP.

Logistic regression was again used to test H_{2e} by investigating the level of association between the UPDR percentage and the logistic transformed probability of a resistance to FP. Specifically, equation [5] (model 2 in Table 4) was developed on a similar basis to equation 4 and was estimated to be:

$$\text{Logit } (p) = C_0 + C_1(\text{UPDR}) + C_2(\text{SIZE}) \qquad [5]$$

Again, as in equation [4], net assets were used as a control variable for size.

The model shown in equation [6] (model 3 in Table 4), uses all variables in equations [4] and [5] and therefore adjusts for any multi-collineality between the variables:

$$\text{Logit (p)} = C_0 + C_1(\text{GER}) + C_2(\text{UPDR}) + C_3(\text{SIZE}) \qquad [6]$$

Results

Table 3 shows the descriptive statistics of the data used to test H_{1e} and H_{2e}. The data was extracted from the published financial statements of those companies that responded to the ASB's 1995 discussion paper. The data in panel A of Table 3 (used to test H_{1e}) excludes the finance companies and is therefore based on only 69 of the original 93 corporate respondents. The data in panel B of Table 3 (used to test H_{2e}) includes the finance companies and is therefore based on the larger sample size of 81 companies. The data in panel C of Table 3 represents the net assets (£bn) of all 81 firms and is used as a control variable to test both H_{1e} (69 observations) and H_{2e} (81 observations). Although all four debt/equity ratios identified above were used to test H_{1e}, only one (long-term debt/shareholders funds – excluding the deferred tax liability as debt) is reported in Tables 3 and 4 [13].

The null hypothesis for H_{1e} expresses no association between debt/equity ratios and lobbying against FP. Panel A in Table 3 reveals that the mean (median) of the debt/equity ratio (Gearing%) of those companies that lobbied against FP was 79.24% (77%) whereas the average ratio was 55.70% (31.00%)

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[13] The results for the other three measures were not significantly different to the findings reported in Tables 3 and 4 and hence are not shown here.

Table 3 Descriptive Statistics for the Sample

Lobbying Position	Number of Companies	Mean	Median	Standard Deviation
Panel A: Gearing %				
Against Full Provision	57	79.24	77.00	46.32
For Full Provision	12	55.70	31.00	7.92
Total (excl. finance)	69	75.92	71.50	52.00
p-value for a 2-sided test of equality		p=0.410	p=0.109	p=0.104
Panel B: UPDR %				
Against Full Provision	63	22.60	14.00	26.5
For Full Provision	18	3.69	0.00	7.95
Total	81	18.64	8.00	18.90
p-value for a 2-sided test of equality		p=0.000	p=0.001	p=0.000
Panel C:SIZE (£bn)				
Against Full Provision	63	2.25	1.58	2.60
For Full Provision	18	2.93	0.58	4.81
Total	81	2.39	1.58	3.14
p-value for a 2-sided test of equality		p=0.595	p=0.341	p=0.019

Note: Gearing % relates to the ratio of long term debt to shareholders funds – excluding the deferred tax liability as debt. UPDR % is the amount of unprovided deferred tax expressed as a percentage of the profit and loss account reserve. SIZE is measured in net assets (£bn). These results were obtained after the exclusion of two outliers who had debt/equity ratios of 1570% and 1136% and UPDR percentages of 3905% and 298%.

for those that lobbied for the proposal. The p-values of a 2-sided test of equality, 0.410 for the mean and 0.109 for the median, suggest that these numbers are not significantly different for the two groups and therefore there is no significant association between financial leverage and the lobbying position on FP. The

results of the logistic regression, which are reported in Table 4 (Model 1), confirm that perception.

Table 4 Results for the Likelihood of Lobbying Against the FP Method

Variable	Model 1	Model 2	Model 3
Observations	69	81	69
Constant	0.725	0.090	0.629
	(0.675)	(0.944)	(0.730)
Gearing %	0.463	-	-0.016
	(0.283)		(0.508)
UPDT%	-	6.652	5.095
		(0.014)	(0.050)
SIZE	0.127	0.128	0.086
	(0.587)	(0.485)	(0.733)
Test that all slopes are zero	(0.731)	(0.005)	(0.143)
Log-Likelihood ratio	-23.665	-30.956	-21.265
Goodness-of-Fit Test	47.329	61.911	42.530
	(0.883)	(0.818)	(0.948)

Note: this table reports the output from a logistic regression where the dependant variable is the probability of lobbying for the full provision method of accounting for deferred taxation. The independent variables include one or more of: Gearing % (the ratio of debt to equity), UPDT% (the ratio of unprovided deferred tax to the profit and loss account reserve), and SIZE (the natural logarithm of net assets (£bn)). The figures in parenthesis are p-values for the tests. The null hypothesis that the population coefficient takes the value zero, against alternative hypotheses that the coefficient of GER is negative, of UPDR is negative, and of SIZE is positive

As anticipated, there is a positive linear relationship between a company's lobbying stance and its debt/equity ratio (Gearing %), but the p-value of 0.283 does not allow us to reject the null hypothesis. This is confirmed by the p value of 0.731 for the test

of slopes, which indicates that neither gearing nor size has a significant regression co-efficient. (The p value of 0.883 for goodness of fit indicates an adequate fit to the observed data.) Therefore, the analysis provides no support for the gearing hypothesis H_{1e} [14]. These results are consistent with those of Dechow *et al*. (1996) and Georgiou and Roberts (2004), who also found no systematic support for the PAT debt hypothesis. The reasons for this result are not clear. It is possible that some borrowing constraints are not influenced by the gearing ratio but are dependent on other measures that are not effected by deferred tax calculations [15].

The null hypothesis for H_{2e} indicates that there is no association between the size of the decrease in revenue reserves and lobbying against FP. Panel B in Table 3 reveals that the mean (median) UPDR percentage for those companies that lobbied against FP was 22.6% (14%) whereas the averages were 3.69% (0.00%) for those that lobbied for the proposal. These numbers indicate that those companies which lobbied against the FP method of accounting for deferred tax might have experienced an average 22.6% reduction in reserves on implementation of the ASB proposals. For those companies who lobbied for the FP method, the average potential reduction in reserves was only 3.69%. The p values of a 2-sided test of equality, 0.000 for the mean and 0.001 for the median, suggest that these numbers are significantly different for the two groups. Results of the logistic regression (Model 2 in Table 4) confirm this, indicating that the coefficient for UPDR percentage is positive at 6.652 and is also significant (p=0.014). Consequently, utilising a conventional level of significance (p=0.05), these results suggest that the null hypothesis can be rejected for H_{2e}. The p value of 0.005 for the

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[14] No significant correlation was found for any of the four debt/equity ratios examined.

[15] For example in terms of operating cashflows or earnings before tax.

test of slopes confirms that at least one of the variables in the model has a significant regression co-efficient. Clearly that variable is UPDT, for size was not significant in model 1. Also the p value for goodness of fit shows an adequate fit to the data.

Overall, these results are consistent with the validity of the dividend hypothesis (H_{2e}). The association between UPDR percentage and a company's lobbying stance might be attributable to factors other than resulting potential constraints on dividend paying capacity. For example, a company that has a US listing might be more likely to lobby for FP given that US GAAP already required the use of FP anyway. Interestingly, only 7 of the companies that lobbied for FP in 1995 had a US listing. It was not therefore possible to include the US listing as a variable in the logistic regression due to an insufficient number of observations, but it is unlikely that such listings contributed materially to the analysis. Given the above mentioned shortcomings of the proxy measures used as an independent variable, and the limited sample of the population tested, the significant findings suggest strong support for H_{2e}.

Combining the data to jointly test H_{1e} and H_{2e} in model 3 of Table 4 merely confirms the findings when the two hypotheses were tested separately. The p value of 0.948 for goodness of fit test for model 3 indicates that this model provides a better fit to the data than either model 1 or 2 and is also adequate. Interestingly, although the direction of the GER variable changes from positive (0.463), as hypothesised, to negative (0.016), it remains insignificant (p=0.508). In contrast, although the coefficient for UPDT decreases slightly from 6.652 to 5.095, it remains significant (p=0.050). (The reduction in the significance of UPDT may be attributable to the smaller sample for model 3 than for model 2.)

Table 4 indicates that SIZE has a positive relationship in all three models, but has no statistical significance in the analysis. All three models provide adequate fits to the data. Comparisons between apparently nested models (eg 2 and 3) are difficult because of the different numbers of observations in each case. However, it is safe to conclude that model 2 is a better fit than model 1 and that the extra explanatory variable of gearing in model 3 does not yield a significant improvement on model 2. In summary, the analysis in table 4 does not support the debt/equity hypothesis H_{2e} but is consistent with the dividend hypothesis H_{2e}.

Despite statistical limitations due to the small number of firms in some classes, Table 5 provides some potential insights into the factors underlying the relationship between UPDR and lobbying against FP. It shows the mean value of the UPDR percentage for each industrial sector of the corporate respondents cross-tabulated against their preferred method of accounting for deferred tax. The results in Table 5 were sorted in ascending order of the UPDR percentage. They suggest that no consensus on a preferred method of accounting for deferred tax emerges among the respondents from those industrial sectors where the percentage is low (for example, technology and finance). However, as the UPDR percentage increases, the respondents tend towards rejecting FP as their preferred choice. Indeed, little more than 10% of respondents with UPDR greater than 20% lobbied for FP and two thirds of them were in the extraction industry where industry specific factors might possibly had an influence. Since the Telecom, Transport, Extraction and Utility industries are capital intensive it seems that the likely effect of the ASB proposals would have been greater in these sectors. This observation is consistent with the earlier comments of Brown (1999) who suggested that the implementation of FRS 19 would be most marked for capital intensive industries.

Table 5 The Preferred Method of Accounting for Deferred Tax by the Corporate Respondents to the ASB 1995 Discussion Paper

	UPDR %	Lobbied Against FP	Lobbied For FP	Total
Technology	0	2	1	3
Finance	2	7	6	13
Health & House	12	3	2	5
Manufacturing	14	10	4	14
Commerce	16	14	2	16
Telecom	21	5	0	5
Transport	21	6	1	7
Extraction	35	4	2	6
Utility	46	10	0	10
		61	18	79

Note: Where UPDR represents the mean of the unprovided deferred tax expressed as a percentage of the profit and loss account reserve for each corporate respondent to the ASB 1995 discussion paper, classified by industrial sector. Of the 81 corporate respondents initially included in this analysis, the results of two companies (with UPDR results of 3905% and 298%) were considered to be outliers and were therefore excluded from the above analysis.

Conclusions

This paper generalised some of the PAT thinking and outlined the PAT debt/equity hypothesis (H_{1e}). It also developed a new dividend hypothesis, arguing that the greater the proportionate reduction in a firm's dividend paying capacity arising from a proposal, the more likely it is that its managers will lobby against that proposal (H_{2e}). These hypotheses were tested by reference to data concerning lobbying behaviour of managers of UK companies during the development of FRS 19 'Deferred Tax' and to the financial statements of those lobbying companies.

Consistent with some previous research, there was no evidence in favour of the gearing hypothesis (H_{1e}). Interestingly, the new dividend hypothesis (H_{2e}) was supported using two logit models (p 0.014 and 0.050 respectively). These results may provide insights into the potential motivations behind the lobbying positions of UK managers. The limited size of the samples involved reduce the extent to which one can claim that the sample represents the population of publicly quoted firms. Nevertheless, the statistical analysis may be judged to be robust so far as the sample is concerned and meets the criteria generally applied by acknowledged experts in statistical analysis. Clearly there are many potential motivations for both the act of commentating on ASB exposure drafts and for the choice of policy that is supported by the comment letter. Not all motivations need be based on the self-interest of the managers or on the interests of the company that they represent. Nevertheless, the statistically significant rejection of the null hypothesis H_{2e} is interesting and suggests a plausible reason for observed lobbying behaviour. That, in turn, may help standard-setters to anticipate and assess the possible significance of lobbying by firms. As always, one can only observe consistency with a hypothesis and not prove conclusively that it actually reflects real-world behaviour.

This paper has some limitations. Much lobbying takes place outside the public domain (Sutton, 1984) and is not directly observable. Therefore it is difficult to study as part of a research project. Consequently, the majority of research in the field of lobbying utilises written submissions, which are readily accessible (Tutticci *et al*., 1994). This paper is also restricted to such submissions and therefore does not necessarily reflect the position of either the population of corporate managers or of those managers who lobbied by other means. Nevertheless, the analysis in this paper should still be valuable, because it supplies evidence

regarding the responses of firms that publicly commented and therefore sought to influence the ASB's decisions. We acknowledge that this form of evidence is not necessarily representative of more extensive populations. It may be possible to address some of these limitations in future research, for example larger sample sizes could be tested including other, albeit less obvious, methods of lobbying. Direct enquiries could also be made of managers who influence the choice of accounting procedures considering (a) the effect that these procedures have on a company's dividend paying capacity and (b) the importance of dividend policy generally when making company reporting decisions.

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