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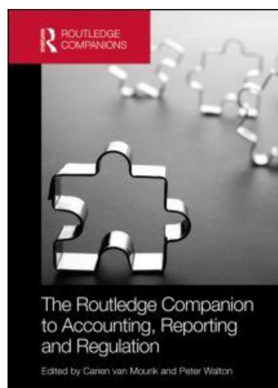

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Influences on the Standard-Setting and Regulatory Process

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Influences on the Standard-Setting and Regulatory Process

Lisa Baudot and Peter Walton

1. Introduction

An accounting standard-setter writes standards that impact numerous interested parties, including governments, institutions and organizations, industry groups and individual users of financial accounting information. As a consequence the standard-setter is surrounded by groups that would like to influence standard-setting in a way which meets their particular goals and needs for information. The standard-setter itself also has interests that come into play, such as the need to create and maintain legitimacy in fulfilling its standard-setting functions. Maintaining legitimacy as a standard-setter often involves retaining governmental support and credibility with interested parties. In the case of an organization such as the International Accounting Standards Board (IASB), which is a free-standing private-sector body not funded by government, its existence depends upon institutions and businesses being willing to finance it and on regulators being willing to use its standards. Therefore, the potential for interested groups to influence standard-setting arises from multiple sources and directions.

The purpose of this chapter is two-fold. First, this chapter introduces the nature of standard-setting influence as distinguished in the academic research literature. Here, influence has been studied primarily as observable participation in the process of standard-setting and, much less so, as less overt outside pressures on standard-setting structures and relations. In introducing the academic perspectives and the importance of considering both we attempt to demonstrate the multiple sources from and directions in which influence on standard-setting can potentially flow. Following on from this, the second part of this chapter takes the development of international accounting structures and regulations in the European Union (EU) as an exemplar through which to demonstrate these sources and directions and show not only how the nature of standard-setting influence affects standard-setting but how standard-setting affects the nature of influence.

1.1 Nature of standard-setting influence

Accounting research offers theoretical perspectives and empirical evidence about influences on accounting standard-setting and regulatory processes from the perspective of observable

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participation in the standard-setting process as well as from the perspective of less overt, but perhaps more compelling, examples of influencing standard-setting.

1.1.1 Influence as participation in standard-setting due process

The majority of research theorizes about the influence of various participants in the due process of accounting standard-setting largely from the standpoint of classical economic and regulatory theory. Such a perspective assumes rational, and therefore self-interested, choice to participate by an interested party. Extending from the economics of regulation theory (Downs, 1957; Stigler, 1971), participation choice research presumes the underlying incentive to participate to be dependent on the benefits expected to accrue from participation less the costs incurred to participate (Watts and Zimmerman, 1978; Sutton, 1984). According to Sutton (1984), where the costs of participating exceed the expected benefits, an interested party is assumed to abstain from participation despite being affected by a proposed accounting standard or change. In other words, those affected by a proposed standard or proposed change will choose to participate in attempt to influence the standard in a way that benefits them but only if the benefits they anticipate outweigh the costs they incur to participate. Often, this is seen to imply that the larger the interested party, the more likely they will be to participate as they will have more to gain (or lose) and greater resources to cover costs of participation.

While the theory of the economics of regulation provides the basis for the majority of accounting research, participation can also be considered through another view often referred to as the 'coalitions of interest' perspective (Haring, 1979; Brown, 1981). This perspective looks to extend the study of participation from the orientation of understanding individual participant decisions to an orientation towards understanding the participation of groups or collectives and the relative influence of those groups on standard-setting decisions. While not contesting the rational decision making view, a collective perspective necessitates a consideration of factors including the potentially evolving and competing logics of different groups and the consensus or conflict both within and between these groups.

Accounting research on the standard-setting process is primarily focused on the choice to participate in a particular standard by different categories of interested parties with presumably different sets of preferences and attributes. In terms of understanding the participation choices of different groups, accounting focuses on the decision of individuals or groups to participate, the frequency of participation and the mode of participation.

Early research examined participation choice in the due process of standard-setting primarily in the context of single issue, single-country studies. These studies were conducted in the domestic, and largely Anglo-Saxon, standard-setting environment of the UK and US with few exceptions (e.g. Watts and Zimmerman, 1978; Schalow, 1995; Weetman *et al.,* 1996; Georgiou, 2002). Following these studies, a number of single-issue, multi-country studies analysed international accounting standard-setting by the IASC and later the IASB (Kenny and Larson, 1993, 1995; MacArthur, 1996).

Single-issue studies analyse participation by interested parties by focusing on one particular standard offering the advantage of simplicity in identifying and measuring participation given the particular attributes of a standard and of the participants. However, this same simplicity also represents a disadvantage in that participation might be better understood by taking a longer view and considering which attributes of standards may drive participation as well as considering the possibility of strategic participation by participants with certain attributes over time.

Researchers attempt to overcome the perceived limitations of single-issue studies by employing a multi-issue approach which involves studying participation on more than one issue over a period

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of time. Multi-issue studies have been conducted in a single-country setting (Puro, 1984; MacArthur, 1988; Tandy and Wilburn, 1992; Saemann, 1999) and more recently in a multi-country setting which involved participation in the study of international accounting standard-setting under the IASC or IASB (Larson, 2002; Kwok and Sharp, 2005; Larson, 2007; Jorissen *et al.,* 2012).

Many studies choose to focus on one interest group at a time; primarily the financial statement preparers and auditors (e.g. Watts and Zimmerman, 1978; Puro, 1984; Schalow, 1995; MacArthur, 1996; Larson, 1997; Georgiou, 2002) since they appear, at least in the studies of Anglo-Saxon standard-setting, to participate to a greater extent than other interested parties. However, a focus only on preparers and auditors, despite representing significant interest groups, ignores the participation of users (i.e. institutional investors, financial analysts, etc.) industry/ trade associations, advisory groups (i.e. the European Financial Reporting Advisory Group, EFRAG), and national standard-setting bodies. The participation of certain groups has also been studied in the literature on coalitions of influence in standard-setting (*accounting firms*: Haring, 1979; Puro, 1985; Mezias and Chung, 1989; Hussein and Ketz, 1980; Brown, 1981; *preparers:* Brown and Feroz, 1992; Saemann, 1995; *users*: Brown, 1981, Saemann, 1999). Results are, however, inconclusive as to the actual extent of influence of coalitions.

Finally, the majority of participation research has been conducted through reference to comment letters issued in response to FASB or IASC/IASB discussion papers (e.g. Watts and Zimmerman, 1978; Georgiou, 2002), interpretations (e.g. Larson, 2002; Larson, 2007) and most often to exposure drafts (e.g. Puro, 1984; MacArthur, 1988; Tandy and Wilburn, 1992; Kenny and Larson, 1995; Larson, 1997; Saemann, 1999). These comments letters are publicly available (i.e. observable) and represent a formal method for participants to express their accounting preferences. Further, a focus on comment letters submitted during one phase of due process neglects consideration of the choice to participate at several points in the due process of standard-setting or not at all.

While participation in due process provides interested parties with an opportunity to indicate their preferences, there remain many open questions as to the how these interested parties attempt to, and the extent to which they actually do, influence the outcome of the standard-setting process both through comment letter submission and otherwise. Further, certain critical aspects of influence such as political and institutional pressures appear not to be considered. These aspects will be discussed in the next section.

1.1.2 Influence as outside pressures on standard-setting structures and relations

In addition to influence as participation in due process, the literature also acknowledges accounting standard-setting influence as political and institutional pressure exerted on standard-setting structures and relations. Similar to the perspectives on influence through participation in due process, political influence (sometimes called the 'politics of standard-setting') can be defined in terms of the self-interested considerations or assertions put forth by a range of parties affected by accounting standard-setting (e.g. Watts and Zimmerman, 1978; Sutton, 1984; Weetman *et al.,* 1996; Zeff, 2002). However, a political perspective goes one step further to emphasize how accounting standard-setting both shapes and is shaped by power relations existing in the society and environment in which standards-setting occurs (e.g. Arnold and Sikka, 2001; Martinez-Diaz, 2005; Perry and Nolke, 2005). These power relations occur between and within different levels including that of the transnational or national-state and government regulatory level, the organizational level (national accounting standard-setters, advisory bodies, professional and industry associations) and at the constituent level (i.e. individual business and investor interests).

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In addition, influence on accounting standard-setting and power relations is affected by institutional pressures where institutions represent formal systems, organizations and regulations and the informal norms, values and shared meanings that underlie them. For example, formal systems influencing standard-setting and power relations include economic systems, political systems, legal systems and the organizational structures which support them (e.g. Tamm-Hallstrom, 2004; Botzem and Quack, 2006; Botzem, 2012). On the other hand, informal norms, values and shared meanings influencing standard-setting and power relations derive from long-established beliefs and behaviours which determine the nature of economic, political, and legal systems and regulations (e.g. Robson, 1991; Young, 1994, 1996, 2003, 2006; Robson and Young, 2009). As such, one can see how institutions themselves can deploy different types of pressures for change or conformity on both standard-setters and interested parties in the standard-setting process.

The great difficulty in assessing what outside pressures come into play on a particular issue is that it may be impossible to see influence being exerted. This may be because pressure is exercised through conversations and leaves no trace, and it may also be that people conceal the fact that influence has been exercised. By way of example, cases in which private meetings have taken place during which certain proposals have been encouraged or discouraged are known to exist but remain confidential. As such, it is impossible to say how widespread is the impulse to conceal the exercise of influence, but even the IASB when meeting in public, and mentioning pressure from outside, tends to suppress the identity of the source.

Further, the existence of influence is also treated differently in different cultures. In the Anglo-Saxon accounting world, the literature until the 1970s tended to suggest that setting accounting standards was a purely technical issue. It was only with Zeff (1978) and Burchell *et al.* (1985) that the literature started to acknowledge that accounting standards had economic consequences and were influenced by behavioural considerations. This contrasts with France where the state, when it created the first national standard-setter in 1946, acknowledged the existence of diverse economic impacts and deliberately set out to include vested interests in the standard-setting process (Scheid and Walton, 1992, p. 115).

The consideration of political and institutional pressures reveals how the seemingly technical act of accounting standard-setting is embedded in and influenced by its environment (e.g. Young, 1994, 1996, 2003, 2006; Botzem and Quack, 2006; Botzem, 2012). As such, understanding influences on accounting standard-setting entails taking a comprehensive view of the complex and on-going interactions and power struggles between a diversity of participants affected by standard-setting set within the context of the social, economic and political environment at the time.

The rest of this chapter aims to illustrate the complexity of these interactions through the emergence and evolution of international accounting regulations in the European Union (EU) and the EU's role in the development of IASB standards. The EU was selected as a focal point for this chapter as it played a central role in the emergence of international accounting regulations and their eventual adoption. Its mechanisms are also relatively transparent and therefore provide an opportunity to see different interests operating to try to influence standard-setting. Given that it is itself an international organization, it also provides additional opportunities to observe competing national interests. However, we would emphasize that we are using the EU as an example of the kinds of influence that are likely to play out in any standard-setting process and not because we believe the EU is particularly active in this way.

The next two sections set international standard-setting within its context by outlining a brief history of the emergence and evolution of international accounting regulations within the EU. As will be shown, the interactions of numerous individual nation-states, regulatory bodies, standard-setting organizations, and constituents are critical to the story and demonstrate the

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dense network of actors and influence which exists in international standard-setting. The last two sections then highlight a number of examples of this network of actors and influence at work in the development of international standards.

2. Emergence of the international accounting structures and regulations in the EU

The development of a set of common accounting standards and its adoption by various national economic systems has been promoted as having important implications for the internationalization of the operations of multinational firms, of governance practices, and of trade flows within the global economy. This 'internationalization project' is often perceived as the outcropping of a more general mission based on a belief in the value of free trade, the elimination of state controls over capital, and economic restructuring of controls such as deregulation and privatisation (Suddaby *et al.,* 2007). As capital markets became increasingly international, the need for a common international language of accounting was advanced as encouraging greater comparability of firms based in different countries but traded in the same capital market (Whittington, 2005). Confusion, uncertainty, inefficiency, and an increased cost of capital were additional reasons put forth as existing when diverse practices were followed and therefore justifying the development of financial statements using a comparable set of (international) accounting standards. The following sections describe the influence of various interested parties in the emergence of international accounting structures and regulations in the EU.

2.1 EU harmonization programme

The EU, at that time consisting of only six countries, embarked in the 1960s on a programme of accounting harmonization which it considered a necessary part of a company law harmonization programme designed to permit the free movement of goods and services across national boundaries. One of the principal instruments of that programme was the Fourth Company Law Directive (1978) which laid out the form and content for individual company financial statements. This directive went through three major drafts, the first of which, issued in 1971 was based largely on the German 1965 Aktiengesetz (Alexander, 1993). Some authors suggest that this first draft was one of the motivations behind the creation of the IASC (Bocqueraz and Walton, 2006). The UK, Ireland and Denmark were in an advanced stage of preparation to become members of the EU, which took place in 1973. However, British accountants were extremely perturbed at the possibility of having to comply with the 1971 draft of the Fourth Directive, and some people (including the president of the American Institute of Certified Public Accountants who was directly involved) thought that this was in the mind of the British accountants who participated in setting up the International Accounting Standards Committee (IASC), the predecessor body to the IASB. The suggestion is they wanted an alternative purveyor of authoritative transnational standards to act as a counter-balance to the EU. We would underline that this example also illustrates the difficulty of proving that influence has been exerted.

In fact the British and Irish opposition to using the 1971 draft Fourth Directive found a different outlet. The EU agreed to modify the 1971 draft, and the next draft, published in 1974 after the UK, Denmark and Ireland had become member states, included a number of features drawn from British and Irish accounting requirements. In particular the 1974 draft included the requirement that the financial statements must give a true and fair view of the company's financial situation – a core UK requirement since 1947. Hopwood (1990) suggests that the UK

and Ireland thought the clause which says that the rules can be set aside if it is necessary to give a true and fair view (this is known as the 'true and fair override') would allow them not to apply the German rules if they did not want to.

The Germans, of course, did not like the override, which breached a principle of German law. The final version of the directive, published in 1978, watered it down slightly by saying that if following the rules did not give a true and fair view, the company should make additional disclosures, and only if that was not sufficient should a rule be overridden. However, the directive is a good example of what happens when different interests collide. The statute says that financial statements must give a true and fair view (UK and Irish requirement) and be prepared following the best principles of accounting (German requirement). It contains numerous optional treatments which were admitted to allow member states not to have to make radical changes. A particularly obvious example is the required formats, which allow four different income statement presentations and two different balance sheet layouts.

The drafting of the fourth directive is also an illustration of the difficulty of disentangling national government interests from private interests. The directives were drafted by a committee consisting of member states' representatives (today's Accounting Regulatory Committee is the descendant of the directive drafting committees). The member states, however, might send along a civil servant and someone from the accounting profession as a technical adviser. A concrete example is Paul Rutteman, who has written about his involvement, as a technical partner in a large international firm and representing the UK professional bodies, in drafting the Seventh Directive, much of which was influenced by the relevant international accounting standard (Rutteman, 1984).

2.2 The end of regional harmonization

Harmonization of financial reporting proved to be a very unwieldy thing. A directive has to be incorporated into national law. When countries amended their company law to reflect the Fourth and Seventh Directives, they typically bolted it on to existing law, so that no two member states actually had the same requirements. On top of that individual states were sometimes slow to adopt a directive (Italy was the last member state to adopt the Fourth Directive, doing so in 1992, 14 years after it was issued and 25 years after work started on drafting it). Germany also had problems and evolved a practical expedient that the true and fair view applied to the notes to the accounts but not the main statements, which had to follow best accounting principles. Many smaller companies in Germany did not like to make all the disclosures required, so there was a massive non-compliance with filing requirements. Failure to file resulted in only a small fine.

The European Commission organized a conference to review harmonization in 1990, and the participants showed little enthusiasm for further improvement. In 1995 the Commission issued a key policy statement, saying that it would abandon regional harmonization and encouraging member states to align their reporting requirements for consolidated financial statements on International Accounting Standards (IAS). The head of accounting at the European Commission throughout this period was Karel van Hulle. He analysed the situation (van Hulle, 2004) as being that many European companies were preparing a second set of financial statements according to US GAAP or IAS. 'This requirement was extremely burdensome and led to confusion about the 'correct numbers' (ibid., p. 355) and the Commission examined four alternatives.

The first was a mutual recognition agreement with the US, but the options in the directives meant that there was no comparability within Europe in how the directives were applied, and mutual recognition with the US 'was not a realistic proposition'. A second solution considered

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was to allow certain large listed companies to be excluded from the directives and allowed to choose another comprehensive basis of accounting. Van Hulle notes that this raised a number of difficult questions, including how to determine the scope of the exclusion. It would involve each member state amending their company law, and abandoning any idea of a homogeneous approach to reporting.

The Commission considered updating the directives, but thought that it would be difficult to decide which issues should be revised, and that member states would want to reopen old issues that they had disagreed with before. The process would take a long time, and the revisions would be out of date before they were published. Another solution would have been to create a Europe-wide standard-setter, but this would have required legislation, and would take both time and money as well as creating a third layer of accounting between international and national.

Van Hulle says:

> The Commission saw no need to develop European standards for the sake of having European standards when other solutions were equally satisfactory. It was also clear a more flexible framework was needed, one that could respond rapidly to current and future developments (ibid., p. 357).

The solution chosen was to recommend that member states aligned their future requirements on those of the IASC. The preference for IAS was justified by the fact that, through the IASC agreement with IOSCO, there was 'a real possibility that in the not too distant future the major securities regulators of the world would accept financial statements based on an agreed set of IAS' (ibid., p. 358). Van Hulle adds that the Commission did not advocate using US GAAP because these had been developed without any European input and were designed to satisfy the needs of the American capital market. The 1995 statement preferring IAS stipulated that these should be followed, as long as they were in conformity with the EU accounting directives. The Commission had also just taken up observer status at meetings of the IASC (Camfferman and Zeff, 2007, pp. 228–9).

The 1995 Communication says that the EU expected to influence the content of international standards by organizing a combined input to the IASC through the 'Contact Committee' (a committee of member state representatives that addressed issues arising out of the accounting directives), although van Hulle (2004, p. 359) notes that individual member states such as France, Germany, the UK and the Netherlands, who were on the IASC board, frequently took different positions from each other and from the Commission's position. The 1995 Communication describes its approach as being 'organized in a pragmatic way' which will 'minimise costs' (ibid., p. 7). It also underlines that the future focus is on consolidated accounts. It says an approach 'including individual accounts would be more likely to run into controversy, since these are in many Member States directly related to reporting for tax purposes'.

This is indicative of the nature of the political compromise between the Commission and the member states. One of the most obvious failures of EU harmonization is in the field of taxation. Despite the central tenet of freedom of movement between member states, and the development of a common currency, harmonized taxation, which would enormously help freedom of movement by companies and economic management, has never advanced. As the 1995 Communication points out, in many states the accounts of individual companies also provide the basis for tax assessment. This is one of the reasons for resistance to accounting directives. The political compromise offered by the Commission was that it would leave member states

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to regulate individual company accounts and the related taxation issues, while the Commission would encourage the use of international standards which had the potential to provide harmonization in consolidated accounts (which have no impact on taxation).

2.3 The IAS regulation

The 1995 Communication was to have unexpected consequences. Having recommended IAS as the basis of future development, the standards were then caught up in the initiative to build a single capital market in the EU. The Financial Services Action Plan on the creation of a single financial market in the EU (European Commission, 1999, p. 7) noted the objectives the Commission wished to achieve in the area of accounting were 'the twin objectives of comparable financial reporting and alignment on international best practice'. The FSAP noted 'Comparable, transparent and reliable financial information is fundamental for an efficient and integrated capital market' and added:

> Capital-raising does not stop at the Union's frontiers: our companies may also need to raise finance on international capital markets. Solutions to enhance comparability within the EU market must mirror developments in internationally accepted best practice. At the present juncture, International Accounting Standards (IAS) seem the most appropriate bench-mark for a single set of financial reporting requirements which will also enable companies (which wish to do so) to raise capital on international markets.

This was followed by the Commission's Communication 'EU Financial Reporting Strategy – the way forward' (European Commission, 2000) which announced the Commission's intention to require EU listed companies to use international accounting standards. Before the issue of this document the EU had been involved in a hard-fought debate with the IASC over the future shape of the IASB. Camfferman and Zeff (2007) devote a whole chapter to this key issue with significant implications for the governance of the future standard-setter. Camfferman and Zeff say (ibid., p. 433) that the EU strongly opposed the structure that was eventually decided upon. They preferred a larger, geographically representative body, while the SEC preferred a smaller, professional board modelled on the FASB.

3. Evolution of international accounting structures and regulation in the EU

This next section looks at how the EU organized itself to adopt IFRS, and the various influences on standard-setting that have occurred in the first decade of the IASB's existence.

3.1 The EU endorsement mechanism

Despite having lost the argument about the structure of the IASB, the Commission went ahead with its announcement of a move to IFRS. In terms of governance, the communication said, 'This strategy will need to take full account of public policy interests' (COM (2000) 359: 7). It proposed that public oversight would be provided through the endorsement function, which would consist of a technical level and a political level. There was no mention of seeking any role in the governance of the IASB.

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However, it suggested that objections to international standards in the endorsement process would be 'probably infrequent' and noted:

> To avoid such a situation concerns about emerging IAS will need to be expressed at the earliest stage in the IASC's drafting process. Indeed, the Union will need to develop internal coordination at all stages of the IAS standard setting process not least to influence the debate. The endorsement mechanism can help coordinate the European position within the IASC (ibid., p. 8).

The Commission decided to require adoption of IFRS through a Regulation, which had to be applied throughout the EU without transposition into national law, to ensure that adoption was uniform. The so-called 'IAS Regulation' (2002-1606) required IFRS to become part of European law through a process known as 'comitology'. A committee of representatives of all the member states is given the power to endorse IFRS into European law. As van Hulle (2004, p. 366) points out, while most people agreed that the choice of IFRS was right, there was considerable opposition to handing over control of accounting standards to a private body: 'Doing so would not conform to the democratic traditions of member states'. There had to be an endorsement system, but 'it was unthinkable that an IAS adopted by the IASB would then need to be re-negotiated at the EU level.'

In order to minimize this possibility, a number of safeguards were put in place. Although the Commission was not given a seat on the IASB, and observer status no longer existed in the new structure, the Commission expected to maintain close links with the IASB and had a seat on what is now the IFRS Advisory Council. The second safeguard was to create a system so that European interests were consulted as early as possible in the standard-setting process. Van Hulle remarks (ibid., p. 367) that there was a high likelihood of different positions being expressed by individual member states and the EU needed to do something to ensure that European interests spoke with a single voice. 'The best way to prevent a possible rejection of an IAS by the EU would be to ensure that there had been proper input from the very beginning and that all arguments had been properly discussed.'

The European Financial Reporting Advisory Group (EFRAG) came into existence. 'This body was set up by the main parties interested in financial reporting (industry, accounting profession, standard-setters, stock exchanges, financial analysts)' (ibid., p. 367). In fact the body not only represented as many people with a probable desire to influence IFRS as possible, but they were also asked to pay for the privilege. EFRAG was set up to run at no cost to the EU. Mr van Hulle approached the Federation of European Accountants (FEE – the long-standing regional body for the profession) to set up EFRAG. FEE then approached other Europe-wide lobbying or representative organizations to participate. The supporters of the organization, who also have seats on its supervisory board, include Business Europe, the European Banking Federation and the European Insurance and Reinsurance Federation.

The fundamental part of the EU endorsement process is that EFRAG interacts with the IASB during the standard-setting process, and aims to coordinate European inputs to that process. When a final standard is issued by the IASB, EFRAG then provides the Commission with a technical assessment (known as its 'endorsement advice'). A later addition is that a further committee, the Standards Advice Review Group (SARG) assesses the EFRAG endorsement to ensure it has not been unduly affected by any one interest group. The Commission puts the standard in front of the Accounting Regulatory Committee (ARC - representatives of the 27 member states) who decide whether or not to endorse it. Informally, the ARC expects a two-thirds majority voting in favour for an endorsement to be made. Over time the procedure has been extended, with the European Parliament having the right to comment on an endorsement during a three-month

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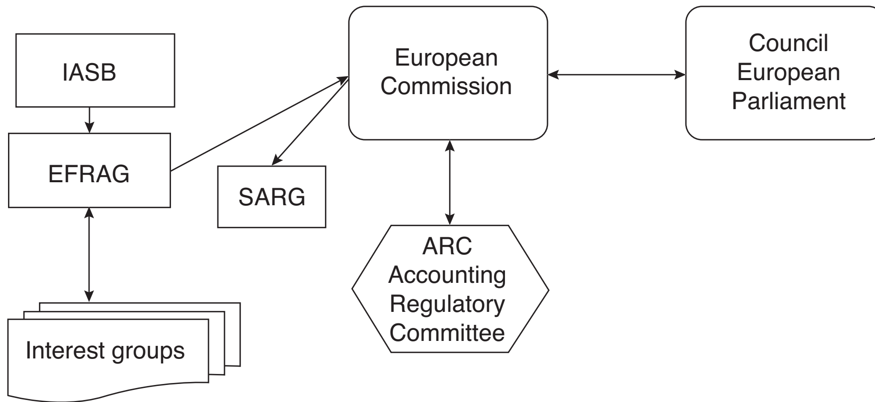

Figure 17.1 EU adoption of IFRS

period after the decision has been made. At the end of the procedure, the Commission submits the decision to the European Council of Ministers for final endorsement (see Figure 17.1).

It can be seen that the EU endorsement mechanism provides one forum for business, the profession and other commercially interested people to give their views, and another for governments. However, the first one includes national standard-setters who may be close to government, and, in the second one, national representatives may have been influenced by their constituents. When EFRAG was set up, the expectation was that the EU would accept IAS/IFRS as issued by the IASB. In an interview, the first chairman of EFRAG, Johan van Helleman, said: 'There is a strong feeling that we should take IFRS as they are. We could provide negative advice to the European Commission, but that should be a very great exception' (WAR, 2001b). However, as we will examine below, the endorsement process provides many opportunities for influence to be exercised. In 2012, the SEC staff in their report on possible US use of IFRS recommend having an endorsement mechanism because:

> an endorsement process may allow a jurisdiction to exert more influence over the standard-setting process because the threat of a potential rejection of a proposed accounting standard may influence the IASB decision on the scope of the accounting standard, how to account for a particular transaction, or the timing of the completion of an accounting standard-setting project (SEC, 2012, p. 3).

3.2 The monitoring board

If, as van Hulle (2004) says, the Commission was initially prepared not to have any direct influence over the IASB, this position changed fairly soon. In 2005 Irish accountant Charlie McCreevy took over the reins as Commissioner for DG Markt (Internal market), which is responsible for financial reporting, and at once organized a meeting with the IASB chairman to discuss a greater role for Europe in IASB governance (WAR, 2005a). The Commissioner, and the European Parliament, repeatedly emphasized that the IASB was not accountable to anyone, and that the countries that used its standards had no oversight of its functioning, which was not acceptable. Oversight was provided by the Trustees of the IFRS Foundation, and Trustees alone were responsible for appointing new Trustees.

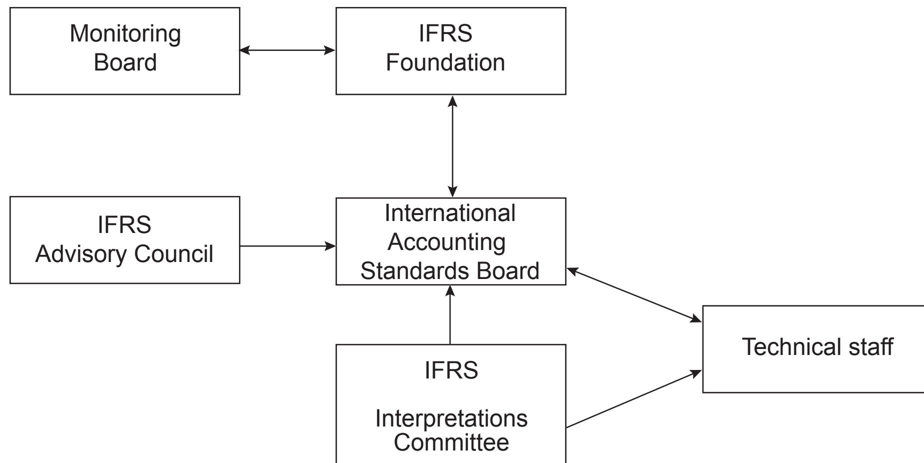

Figure 17.2 The structure of the IFRS Foundation

The Trustees subsequently reviewed the IASB constitution (which is done on a systematic basis) and created a new oversight body, the Monitoring Board, which would have no direct link with the IASB, but which would have the right to review all decisions made by the Trustees. The Monitoring Board came into existence in 2009 and consisted of five members: the European Commissioner responsible for the Internal Market, the chairman of the SEC, the chairman of the Japanese Financial Services Agency and two representatives of IOSCO. A process had been created which provided direct influence on the major decisions concerning the standard-setter, albeit excluding in theory the technical decisions (see Figure 17.2).

One of the key areas where the Monitoring Board has since exercised its influence was in the appointment of the new chairman of the IASB. Sir David Tweedie's two terms came to an end in June 2011. The Trustees proposed Ian Mackintosh, an experienced Australian accounting regulator, who was then chairman of the UK Accounting Standards Board. The Monitoring Board refused to confirm the appointment, apparently at the instigation of the European Commission, and the Monitoring Board's then chairman, Hans Hoogervorst, a non-accountant, was given the post. Mr Mackintosh was appointed as vice-chairman.

In the following two sections we will look at a series of examples of the network of actors and influence at work in the EU concerning the development of international accounting standards as such. The first deals with financial instruments, and the second other technical accounting issues.

4. Financial instruments

How to account for financial instruments has been a controversial and complex issue for more than two decades. The central issue is that instruments that have little or no cost at inception may bind a company into substantial potential gains or losses of which no indication is given on a historical cost measurement basis. Traditionally accounting has used current market value as a surrogate when historical cost is not available or not relevant, and that was proposed for financial instruments, but with the criticisms that (a) it imports market volatility into the financial statements, (b) the current market position is not necessarily any indication of the value at which a transaction will be realised, and (c) current market values

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are only available for a limited number of items, and estimates lack the objectivity claimed as an advantage for fair value.

4.1 IAS 39 and the JWG draft

The IASC's financial instruments project started in 1988 and resulted in the approval of IAS 39, a 'temporary' standard, in December 1998 as a last ditch move to complete the IASC's development programme agreed with IOSCO (Cairns *et al.,* 2002, pp. 364–70). The IASC had agreed in 1997 to participate in a project initiated by a group of Anglo-Saxon standard-setters to develop a single internationally agreed financial instruments standard. This group set up what was called the Joint Working Group (JWG) and included Australia, Canada, Japan, New Zealand, the USA and then Germany, France, the UK and the Nordic Federation. The JWG produced a draft standard which was intended to replace the 'temporary' IAS 39. However, although the French had participated in the development of the proposal, when it was unveiled in December 2000 it was greeted with much opposition in France; the French participants in the JWG therefore withdrew their approval, and the successor to IAS 39 went no further.

One of the difficulties in EU adoption of IFRS was that the ARC had to endorse all the pre-existing IFRS, which also implied that EFRAG needed to prepare endorsement advice, an enormous task for a fledgling organization. Eventually it was agreed that IAS 39 and IAS 32 would be deferred and addressed separately, after adoption of the other standards in 2003.

4.2 The Chirac letter

In July 2003 the French president, Jacques Chirac, wrote to Romano Prodi, president of the European Commission, asking him to review the adoption of IFRS in general and IAS 39 in particular. The letter talks about the excessive importance given to market value which creates volatility in the financial statements. Mr Chirac said adoption of IAS 39 'would have negative consequences for financial stability'. He also said: 'It seems to me essential that the European Union, the Commission and the Member States should have more weight in the elaboration of standards by the IASB'. It is generally believed that this overtly political intervention was motivated by French banks, who throughout the development of IAS 39 had taken a strong role in the accounting committee of the European Banking Federation in opposing the standard.

4.3 Macro-hedging requirements

When the IASB came into existence it went through the formal process of confirming all the IASC's standards, but in the light of reluctance on the part of some board members to endorse what they saw as flawed standards, the IASB also agreed to undertake an 'improvements' programme to address known problem areas without redebating the underlying standards. IAS 39 was put into this programme, and the IASB was asked by the European Banking Federation to grant more flexibility in accounting for macro-hedges.

Essentially the issue was that IAS 39 has an anti-abuse stance on hedge accounting (Hague, 2004). A concern when it was written was that companies would designate hedging instruments retrospectively to achieve desired performance effects. The standard therefore requires that hedges are designated at inception on an instrument by instrument basis. However, the

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banks argue that much of their hedging is not done instrument to instrument but by portfolios, and that often they aim to hedge only a part of the risk. This is referred to as 'macro-hedging'. A committee of IASB members, under pressure from the Commission, and European bankers spent something like two years discussing how IAS 39 could be amended to provide some relief. The IASB did provide relief but the bankers said that what was afforded was inoperable.

4.4 The fair value option

Another problem raised by bankers was that of an 'accounting mismatch' between liabilities held at fair value and assets which economically were held to back the liability, but were accounted for at historical cost: the accounting did not reflect the economics. The IASB eventually provided a solution for this that was known as the 'fair value option'. The fundamental notion was that the IASB believed that accounting for financial instruments at fair value always gave better information for investors. Therefore it was prepared to allow preparers an option to use fair value if they wished to.

This proposal was exposed for comment in the normal way and subsequently redebated and finalized, after which the IASB received a letter from the European Central Bank saying that it opposed the fair value option. It believed that this would allow banks to inflate their assets for prudential regulation purposes and it was not prepared to allow this. Despite the fact that due process had been completed, the IASB reopened the subject and, in consultation with the European Central Bank, introduced restrictions on the use of the option.

4.5 The carve-out

It was clear that IAS 39 was going to be the most difficult legacy standard to be endorsed by the ARC. In the first instance EFRAG was unable to give endorsement advice. EFRAG's voting arrangements put obstacles in the way of the organization disagreeing with a standard. Approval required only a simple majority of those voting, while a recommendation not to endorse required a two-thirds super-majority. In between those two positions, EFRAG simply did not give advice one way or the other. Six members of the eleven member EFRAG Technical Expert Group had dissenting opinions on IAS 39. They claimed the standard did not have the qualities required by the IAS Regulation and did not give a true and fair view (Walton, 2004, p. 6).

There was a danger that IAS 39 would not be endorsed. Karel van Hulle (making a presentation at an event to mark the tenth birthday of EFRAG), reported in WAR (2011) said that the Commission had devised the idea of the carve-out. The IAS Regulation (2002-1606) says the ARC must either reject or accept a standard, it does not allow for changing the standard. However, the Commission asked themselves if they had the power to remove something and decided that they did, which was a better solution than rejecting a core standard. In Mr van Hulle's view, had they not come up with the carve-out they would not have reached the tenth birthday of EFRAG.

The EU's Accounting Regulatory Committee (ARC) voted on 1 October 2004 to approve IAS 39, minus the provisions on fair value and portfolio hedging of core deposits. This has subsequently been known as the carve-out.

4.6 Reclassification of financial instruments

The 2007 financial crisis generated a major confrontation between the EU and the IASB. IAS 39 provides four classifications of financial instruments depending on the preparer's business

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intentions for the instrument. To prevent profit manipulation by retrospective designation, the standard requires classification to be done at inception, thereafter it is irrevocable. This requirement was stressed by the state of the financial markets: instruments held in the 'available for sale' category have to be valued at fair value, but because of the reluctance of people to trade (liquidity preference) market values were less than the expected contractual cash flows of some assets. Financial institutions wanted to reclassify from available for sale to 'held to maturity' on the basis that they would realize more cash by holding the asset and it would not be valued at fair value.

The details of the political manoeuvres are given in André *et al.* (2009). Essentially the French government persuaded the European Commission to draft a further carve-out from IAS 39 which would remove the prohibition on reclassification. In October 2008 the Council of Ministers then told the IASB that it must amend IAS 39 to allow reclassification, or the ARC would apply its carve-out. The IASB took emergency powers to amend the standard as the Commission asked. Sir David Tweedie subsequently commented that in amending the standard the IASB were able to insert disclosure requirements about any reclassification, which would protect investors. The ARC could only remove clauses, it could not add anything.

4.7 Non-endorsement of IFRS 9

A by-product of the October 2008 reclassification confrontation was the EU insistence that the IASB rush out a replacement standard by the end of 2009. The IASB was already working on a two-classification model for financial assets. It was well aware that a complete replacement of IAS 39 within a one-year time frame was impossible, so it opted for a phased replacement of IAS 39 by IFRS 9. It duly completed the financial asset part of IFRS 9 and this was issued in final form early in 2010, with an implementation date of 2013. However, when this was put forward to the ARC by the Commission, the German delegation voted against it, and persuaded a sufficient minority to follow them, so IFRS 9 was not endorsed into European law, despite the Council of Ministers having expressly asked for that in 2008.

The explanation given is that there had been a change in the composition of the German coalition government in the interim, which had placed a new team in the Ministry of Justice, which is responsible for financial reporting. The new team were unwilling to endorse IFRS 9 without knowing what the rest of the standard would look like, even though all parts would have been submitted individually. The application date of IFRS 9 was initially January 2013, but the IASB put this back to January 2015 once it was clear that all parts would not be completed by then. At the time of writing, there remains a clear risk that the official application date will arrive before the ARC endorses the standard.

Another consequence of the 2008 crisis was, as mentioned above, that IFRS 9 would be issued on a phased basis. There are now three versions of IFRS 9, those of 2010 (financial assets), 2011 (financial assets and liabilities) and 2013 (financial assets and liabilities, and general hedge accounting). Outside of the EU preparers can use any of these three or just stay with IAS 39. This has a very negative effect on the comparability of financial statements.

4.8 An exception to debt/equity classification

The dividing line between debt and equity is one of the most difficult and crucial issues in regulation. IAS 32 *Financial Instruments: Presentation* takes a restrictive but clear view that any financial instrument that *requires* the reporting entity to make a payment to the holder is debt and not

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equity. In 2008 the IASB modified this for certain securities. The problem that gave rise to this was first raised by New Zealand farm cooperatives, but the issue also arises with partnerships and the German standard-setter took an active role in finding a solution because the jurisdiction has legal vehicles that include limited partners. We are therefore including it at the end of the financial instruments section for the sake of completeness.

The technical issue is that in some corporate forms equity-holders are required, if they wish to cease to participate, to sell their stake back to the reporting entity, and the entity is required to purchase them. Under IAS 32, such an arrangement causes the instrument to be treated as a liability. In the case of a cooperative, for example, this may mean that (a) all its equity is classified as debt, and (b) that every period in which it makes a profit causes the liability to be increased, which generates a loss.

The IASB was sympathetic to the problem and an amendment to IAS 32 was passed, allowing such instruments to be classified as equity, while setting restrictions on the use of this exception. The existence of this requirement was subsequently to be one of the complicating factors in the attempt to reach a joint standard with the FASB on distinguishing equity instruments from debt instruments. That project has been shelved indefinitely after numerous attempts to devise a workable formula.

5. Other technical issues

Although financial instruments has been one of the most difficult areas for standard-setters, particularly during a period of prolonged financial crisis, they have not been the only source of constituent problems for the IASB and the EU. In this area the work of the IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee – IFRIC) has also been subject to the exercise of competing interests.

5.1 Emissions trading schemes

One of the issues that the IASB was slow to address in relation to preparing for the 2005 switch to IFRS by the EU was the need for some guidance on how to account for the emissions trading scheme that the EU had initiated. This scheme provides for companies that emit greenhouse gases to be given a reducing annual allowance for authorized emissions. Companies exceeding their allowance have to buy more, those not using their allowance can sell on the market. The IASB chose to ask IFRIC to issue an Interpretation, rather than set out to write a new standard.

The consequence of this was that the guidance could only be on how to apply existing standards. The result was IFRIC 3 *Emission Rights* which provided guidance based on IAS 38 *Intangible Assets*, IAS 37 *Provisions* and IAS 20 *Government Grants*. Essentially the Interpretation said that allowances should be recognized as an intangible when acquired, and measured at fair value, and that the obligation to surrender the rights should be recognized progressively as emissions took place, being measured at fair value also.

European constituents thought this was a counter-intuitive solution, since the use of fair value measurement at different times meant that the allowance received and the allowance subsequently surrendered could be measured differently, giving rise to a profit or loss. Economically there was neither a profit nor a loss. EFRAG consistently produced negative comments on the Interpretation and in 2005 gave negative endorsement advice to the Commission (WAR, 2005c). The IASB withdrew the Interpretation. This is actually the only time that EFRAG has,

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to date, refused to endorse an IASB pronouncement. It did not produce the shockwaves that would have been feared five years' earlier, when EFRAG was being designed.

5.2 Concessions

A similar situation presented itself with IFRIC 12 *Service Concession Arrangements*. The IASB's agenda was heavily committed, but IFRS had no rules for accounting for government and similar concessions, a type of transaction that was not common in the Anglo-Saxon accounting world, but was significant in a number of European countries. These are arrangements whereby, for example, the government grants a contract to a private sector company to build infrastructure, such as a motorway, and the company subsequently operates the motorway, either for a fee or through levying tolls. The IASB was reluctant to address this as a standard-setting issue and passed it to IFRIC to say how existing standards should be applied.

There was much debate about the issues lasting several years, but IFRIC 12 ruled that, where ownership of the infrastructure asset passed to the government sponsor in return for the right to raise future revenue, the concession operator should recognize an intangible. This brought considerable opposition, notably from Spain, where concession operators would find themselves showing intangible assets where previously they had recognized a tangible. They argued that this would have significant economic consequences because banks would apply less favourable lending rules for an intangible as compared to a tangible asset.

EFRAG spent a long time debating this issue, and it seemed in January 2007 that there was not an absolute majority for giving favourable endorsement advice. EFRAG had further meetings and finally issued a favourable endorsement in March, accompanied by dissents from three out of twelve TEG members (WAR, 2007). Spain also opposed endorsement of the Interpretation by the ARC, but was unable to muster a blocking minority.

5.3 Statement of comprehensive income

The IASB and FASB had embarked upon a joint process to revise financial statement presentation. This was split into phases, and in the first phase, both standard-setters were to introduce a Statement of Comprehensive Income to replace the Income Statement as well as that part of the Statement of Changes in Equity that addresses those changes in equity that are not exchanges with shareholders. The IASB already had an optional statement, the Statement of Recognized Income and Expense, which was little used. It issued an exposure draft in 2008 mandating a single statement of comprehensive income. This caused negative feedback from companies, particularly in Europe.

The IASB was puzzled by the response because it considered that it was not asking for any disclosure of information that was not already provided in the financial statements. However, it was clear that companies thought that analysts would look at the comprehensive income number for the year instead of the operating profit as the basis for forecasts. The corporate reaction raises an interesting question as to how efficient capital markets are in incorporating publicly available information.

At a public standard-setting meeting in November 2005, the IASB noted the strong opposition, especially from the European Round Table of Industrialists, and conceded that the statement could be broken into two parts, operating income and other comprehensive income, to be shown on separate pages (WAR, 2005b). Deputy Chairman Tom Jones is reported as saying that a fight over two pages instead of one was not something the IASB needed.

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5.4 IFRS 8 operating segments

An extreme example of political intervention in standard-setting occurred with IFRS 8: the standard was endorsed by the ARC, and therefore was ready to enter European law, when the European Parliament intervened to try to stop it. It took the European Commission a great deal of effort to persuade the Parliament eventually to drop its opposition.

IFRS 8 was an example of what the FASB and IASB called 'short term convergence'. This was a scheme, now dropped, whereby if one standard-setter had a more recent standard on a subject where both had a standard, the other would adopt the later one as being more up to date. The IASB's standard, IAS 14, had originally been issued in 1981 along similar lines to US and Canadian standards. But the FASB had subsequently revised its requirements with a new standard, SFAS 131. The US standard moved to an approach known as 'through the eyes of management'. Where the earlier standards had mandated a split of selected consolidated information across industrial and geographical segments, the new standard said that the segment information should be what was used by the Chief Operating Decision-Maker (CODM) for management purposes.

The fundamental idea was that previous segment information was often a compliance exercise involving the preparation of data broken out from the consolidated statements and not reflecting how the company saw its activities. The SFAS 131 argument was that information used for decision-making by management was more useful for investors (and reduced information asymmetry). The argument against this approach was that (a) the figures were not necessarily GAAP-based, and (b) they were not comparable between companies. US research tended to show that post-SFAS 131 more segments were actually reported by companies.

The IASB decided, in conjunction with the FASB and the SEC, that convergence on segments was desirable, and that the more recent US standard should be used. IFRS 8 is in effect SFAS 131, amended for different vocabulary used by the two standard-setters. An exposure draft was issued in 2006 and the final standard early in 2007. After endorsement by the ARC, the European Parliament has a three-month window in which to comment, if it wishes to. In this case British investment analysts lobbied the Economic and Monetary Affairs Committee of the European Parliament, saying that IFRS 8 would result in worse information for investors. The Commission and the Parliament agreed that the three-month window would be extended, both institutions would prepare studies, and Parliament would debate the issue later in the year.

Parliament commissioned Nicolas Véron from the Bruegel Institute to write a report. This was released in September and claimed that the IASB had ignored 'widespread negative sentiment' and that there were insufficient safeguards to ensure that segments reflected economic reality and conveyed a proper understanding of risks. He recommended that the EU should not adopt the standard. The Commission, for its part, had put out a questionnaire to assess the probable effects of the standard. Its report, European Commission (2007), concluded that the management approach had an overall positive effect on the quality of information, gave increased usefulness and relevance and appropriately addressed the needs of global users of financial information. The European Parliament finally agreed to endorse the standard in November 2007.

5.5 IFRS 10 implementation date

The IASB issued three related standards, IFRS 10 to IFRS 12 in 2011 for application from January 2013. IFRS 10 is a major standard dealing with consolidation, while 11 and 12 address

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accounting for joint arrangements and disclosures concerning activities with related companies. The IASB also decided to work on an amendment to IFRS 10 in order to specifically exempt from consolidation subsidiaries of investment companies that were managed on a fair value basis as an investment and not as a part of the parent's operations. IFRS 10 has slightly changed the basis on which a consolidation decision is made, and the investment company exemption would avoid financial institutions having to consolidate as operating subsidiaries their investment funds. These are to be accounted for at fair value. The accounting for joint arrangements and the new disclosures called for a different approach to joint ventures.

While EFRAG accepted the standards, it firmly believed that the implementation date should be a year later, because its constituents had told it that they needed time to obtain the necessary additional information and to reassess previous consolidation decisions. They also feared that the investment company exemption would not be available by January 2013 and some investees could potentially be treated as operating subsidiaries for one year. They wrote to the IASB in late 2011 to ask the IASB to reconsider, which it duly did, but noted that (a) the standards were part of the IASB's commitment to the G20, and (b) some countries had already adopted the standards early.

EFRAG subsequently gave positive endorsement advice to the European Commission, but at the same time recommended that the application date should be January 2014 and not 2013. The ARC, meeting in June 2012, followed the recommendation, and so the three standards have an application date in Europe which is different to that of the IFRS as issued by the IASB.

The standard is still the subject of discussion, however, since the European Securities and Markets Authority (ESMA), the Commission's stock exchange oversight body, has subsequently expressed concerns about how the standard is being applied, and in 2011 asked the IASB to give further guidance on the identity of the CODM – which the IASB refused to do.

6. Conclusion

This chapter is not an attempt to go deeply into the workings of different influences on accounting standard-setting, but rather it presents a sequence of events which took place over a long period and are intended as an example of how some influences can be seen to operate on standard-setting. The example we have chosen relates:

- to the emergence and evolution of international accounting structures and regulations in the EU in general; and
- to the EU presence in the development of specific IASB standards, to demonstrate that there are numerous institutional influences at work in the standard-setting process and these are rarely absent.

The chapter builds on the previous work of Walton (2009) in suggesting that a number of workings of influence exist by nature of the EU's institutional arrangements for accounting regulation. More specifically, this chapter represents an early attempt to show that the institutional arrangements created by the EU in support of a single financial market and common set of financial reporting standards present numerous opportunities for influence to be exerted, both by those institutions and by other institutions and individuals who wish to influence standard-setting outcomes.

We envision that if an historical account of the presence of American capital market interests in the emergence and evolution of international accounting structures and regulations and the

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development of specific IASB standards, or more particularly standards undergoing convergence with US GAAP, had been referenced as an exemplar, our conclusion would have likely been similar – that institutional arrangements supporting of global financial markets and global accounting standards have generated numerous opportunities for influence by American capital market interests.

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