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An examination of international accounting standard-setting due process and the implications for legitimacy

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ABSTRACT

This paper explores the due process of accounting standard-setting by focussing on relative levels of stakeholder and jurisdictional influence. We draw on legitimacy theory to explain our findings and ask what implications any bias might have for the IASB. This study extends the standard-setting literature in three ways. First, we create a weighted coding system to analyse the content of comment letters. Second, we test for differences in the acceptance rate of comments made by stakeholders and by jurisdictions. Third, we analyse IASB discussion documentation that sheds light on the decision-making process. Previous studies have focused on whether outcome-oriented proposals are 'influential' (persuasive) by focussing on success rates measured as proposed changes being accepted. We widen this definition to include whether constituents' views are discussed. We find that accounting firms appear to have significantly less influence than other stakeholders. We also find that the IASB reacts less favourably to UK proposals but comments from the US are more likely to be discussed. A lack of fairness (real or perceived) could jeopardise perceptions of the procedural legitimacy of the due process and ultimately impair the IASB's cognitive legitimacy.

1. Introduction

> *"The genius of the FASB's due process is the cultivation of the belief among constituents that their input exerts some degree of influence upon the ultimate content of standards."* Fogarty (1994: 220).

Fogarty's (1994) review of the FASB standard-setting process identified a series of constraints, opportunities and dilemmas. The question of whether certain stakeholder groups hold greater levels of (relative) influence has been the subject of much work and researchers have studied this phenomenon in both domestic and international contexts (e.g. Cortese, Irvine, & Kaidonis, 2010; Kwok & Sharp, 2005; Martens & McEnroe, 1991, 1998). Almost invariably, influence and legitimacy are considered together (Burlaud & Colasse, 2011; Chua & Taylor, 2008; Danjou & Walton, 2012; Hussein & Ketz, 1991; Larson, 2002; McEnroe, 1993; Suchman, 1995; Tutticci, Dunstan, & Holmes, 1994). This paper reviews the IASB's standard-setting due process in relation to the complex and controversial subject of financial instruments disclosures (International

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Financial Reporting Standard 7 *Financial Instruments: Disclosures* [IFRS 7], 2005) through the lens of legitimacy theory. In particular, this study investigates the following research questions (RQ):

RQ1: Is there evidence that certain stakeholder groups are more influential (measured in terms of (i) discussed and (ii) accepted proposed changes) than their peers in the financial instruments disclosure standard-setting process?

RQ2: Is there evidence that constituents in certain jurisdictions are more influential than others in the financial instruments disclosure standard-setting process?

This study is motivated, at least in part, by criticisms of, and challenges to, the IASB's procedural legitimacy (e.g. Burlaud & Colasse, 2011; Kwok & Sharp, 2005; Larson & Herz, 2013). This is an important issue within an accounting standard-setting context. Procedural legitimacy is a type of moral legitimacy which can be created (lost), maintained, and built (impaired) according to levels of perceived independence and impartiality (Suchman, 1995). Suchman (1995) distinguishes legitimacy into three primary forms: pragmatic, moral and cognitive. These are known to co-exist, overlap and intertwine (Brinkerhoff, 2005; O'Dwyer, Owen, & Unerman, 2011) and prior work suggests that there is a "durability pendulum" (O'Dwyer et al., 2011: 36). Pragmatic legitimacy is considered to be the easiest form to obtain but the least durable, whereas cognitive legitimacy is the most difficult to obtain but the most durable once it is there (Cashore, 2002; Kumar & Das, 2007; O'Dwyer et al., 2011). Cognitive legitimacy is the result of constituents' long-term experiences and their perceptions of the organisation's on-going pragmatic and moral legitimacy (Kumar & Das, 2007). Thus, concerns over the moral (procedural) legitimacy are not only immediately problematic, but they also put at risk levels of pragmatic and cognitive legitimacy (O'Dwyer et al., 2011).

On the one hand, some believe that the answer to the IASB's procedural legitimacy problem lies with the provision of greater transparency and hence there have been calls over the years for improvements (Stenka & Taylor, 2010; Tutticci et al., 1994; Yen, Hirst, & Hopkins, 2007). On the other hand, increasing transparency is likely to be self-defeating as it exposes the processes to public scrutiny (Herbohn & Herbohn, 1999: 421) and does not necessarily lead to better decision-making. Johnson and Solomons (1984) argued that open public debate was required to justify decisions made and actions taken; without this, there are fears that this process might be viewed as symbolic rather than substantive (e.g. Fogarty, 1994; Weetman, 2001). This is an important issue which can now be addressed.

The IASB has responded to these transparency concerns by making available documentation dating back to 2001 which includes Board minutes, technical working group minutes and staff observer notes.[1] This study considers the evolution of IFRS 7 from initiation (2002) through to approval (2005). Due to the complex and controversial nature of financial instruments reporting (Gebhardt, 2012), both the accounting community and standard-setting bodies' credibility as an authority have been brought into question (Le Guyader, 2013). Hence, we should not be surprised if the Board allowed themselves to be guided by constituent opinion during the due process to maintain its perceived legitimacy (Richardson & Eberlein, 2011). The principal advantages of examining IFRS 7 are: first, documentation relating to meetings of the Board and technical working group was available covering the whole period; second, this is an area where there were strongly competing interests and conflicting opinions between stakeholders and across jurisdictions; and third, there have been *ex-post* criticisms of IFRS 7's requirements (Burlaud & Colasse, 2011; Gebhardt, 2012; Harrington, 2012; Walton, 2004).

Until now, prior work has relied almost exclusively on vote-counting systems to measure the relative influence of stakeholder groups – largely overlooking the potential implications of jurisdictional bias (see Zeff, 2002, 2007) and ranking comments equally (see McEnroe, 1993) – and defined constituent success as the number of comments accepted as a proportion of those made (e.g. Kwok & Sharp, 2005; Yen et al., 2007). One problem with this narrow definition of success is not one-dimensional. This study aims to refine and improve this definition as well as proposing a workable methodological approach which future researchers might employ.

Early work clung tightly to the underlying presumption that respondents actively supported (opposed) regulations that promoted (frustrated) self-interest during the due process (Cooper & Sherer, 1984). Whilst this may be one explanation, the position has been modified and extended over the years and most commentators now agree that the active engagement of stakeholders stems from a political and social agenda as much as a technical one, i.e. not necessarily dominated by the

[1] For ease of access reasons, we would recommend that researchers who are interested in reviewing the widest possible range of IASB documentation available, might consider those standard-setting projects which are either recently completed or on-going. While it is possible to access summaries of Board discussions from 2001 onwards (http://www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx), for projects pre-2006 (note: it is possible that this date will shift forward as time elapses), much of the remaining detail including comment letters, observer notes and details of joint working group meetings have been archived (link to all projects since 2006 in alphabetical order: http://www.ifrs.org/Current-Projects/IASB-Projects/Pages/All_projects.aspx). For projects that pre-date these, details can be requested directly from IASB staff and it is useful to contact the technical officer heading up the working group. For example, during our study we contacted the technical officer in charge of the financial instruments working group. It is also useful to note that through the search function of IFRS.org archived information can be found e.g. the first 50 comment letters related to ED 7 can be found at: http://www.ifrs.org/Documents/Disclosures10041_50.zip. Constituents also make information available through their websites. However, to ensure completeness in the data gathering exercise, it is important to know what you are searching for. To this end, Deloitte's IAS Plus resource is helpful in filling the gap. This site provides a full suite of documents released by the IASB as well as other stakeholder organisations. This is updated on a monthly basis and, by way of illustration, the link to ED 7's release can be found at: http://www.iasplus.com/en/news/2004/July/news1406. Furthermore, the Big 4 accounting firms write up their own observer notes for IASB meetings and make them available on their websites. For example, the following is a link to Deloitte's observer notes from the 'Disclosure Initiative' meeting held during October 2014: http://www.iasplus.com/en/meeting-notes/iasb/2014/october/disclosure-initiative-2. Many of the large accounting firms also provide guidance notes and commentary to their (current and potential) clients which are available online, for instance, a link to PwC's financial reporting guidance can be found at: http://www.pwc.com/gx/en/ifrs-reporting.