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Sebastian Botzem

The Politics of Accounting Regulation

Organizing Transnational Standard Setting in Financial Reporting

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Edward Elgar

Cheltenham, UK • Northampton, MA, USA

Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2011932889

MIX
Paper from
responsible sources
FSC® C018575

ISBN 978 1 84980 177 5

Typeset by Servis Filmsetting Ltd, Stockport, Cheshire
Printed and bound by MPG Books Group, UK

Abbreviations

AASB	Accounting Standards Board, Australia/New Zealand
AcSB	Accounting Standards Board, Canada
AICPA	American Institute of Certified Public Accountants
AISG	Accountants International Study Group
AMF	Autorité des Marchés Financiers, France
ARC	Accounting Regulatory Committee, EC
ARG	Analyst Representative Group
ASB	Accounting Standards Board, UK
ASCG	Accounting Standards Committe of Germany (see DRSC)
CEA	European Insurance Association
CFA	Chartered Financial Analyst Institute
CICA	Canadian Institute of Chartered Accountants
CNC	Conseil National de la Comptabilité, France
DCF	discounted cash flow
CSRC	China Securities Regulatory Commission
DRSC	Deutsches Rechnungslegungs Standards Committee
DTT	Deloitte Touche Tohmatsu
E+Y	Ernst and Young
EACB	European Association of Co-operative Banks
EC	European Commission
ECB	European Central Bank
ECOFIN	European Council of Economic and Finance Ministers
ECOSOC	Economic and Social Council
EFAA	European Federation of Accountants and Auditors
EFFAS	European Federation of Financial Analysts Societies
EFRAG	European Financial Reporting Advisory Group
ERT	European Round Table
ESBG	European Savings Banks Group
EU	European Union
FASB	Financial Accounting Standards Board, USA
FBE	European Banking Federation
FEE	Fédération des Experts Comptables Européens
FEI	Financial Executives International
FESE	Federation of European Securities Exchanges

FSA	Financial Services Authority, UK
FSB	Financial Stability Board
FVA	fair value accounting
IAFEI	International Association of Financial Executives Institutes
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
ICAEW	Institute of Chartered Accountants in England and Wales
ICFTU	International Confederation of Free Trade Unions
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Standards Interpretations Committee
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ISAR	International Standards in Accounting and Reporting
ISO	International Organization for Standardization
KPMG	KPMG (Klynveld, Peat, Marwick and Goerdeler)
MPIfG	Max Planck Institute for the Study of Societies
OECD	Organisation for Economic Co-operation and Development
PAAinE	Pro-active Accounting Activities in Europe
PwC	PricewaterhouseCoopers
P&L	profit and loss account
SAC	Standards Advisory Council
SEC	Securities and Exchange Commission, USA
SIC	Standing Interpretations Committee
SME	small and medium-sized enterprises
SWP	Strategy Working Party
UEAPME	European Association of Craft, Small- and Medium-sized Enterprises
UEC	Union Européenne des Experts Comptables, Economiques et Financiers
UNCTAD	UN Conference on Trade and Development
UNICE	Union of Industrial and Employers' Confederations of Europe
US GAAP	United States generally accepted accounting principles

Acknowledgments

Like most books, this one would not have been written without the contributions of many colleagues and friends who helped and encouraged me along the way. I would like to thank them for making this publication possible. Most of the conceptual ideas originated during my time at the doctoral program "Research on Organizational Paths" at the Free University of Berlin. I would like to explicitly thank Sigrid Quack for many comments and suggestions, as well as Jörg Sydow and Leonhard Dobusch. My colleagues at the Social Science Research Center, Berlin were always willing to listen, discuss, and provide helpful observations to improve my argument. Most of all, I would like to thank Arndt Sorge, Dieter Plehwe, Jeanette Hofmann, and Holger Straßheim. While doing field research, I particularly profited from exchanges with members of the LSE Department of Accounting, as well as encouraging and insightful discussions with Anthony Hopwood. My interview partners were very kind in answering many questions and sharing with me their reflections on, insight into, and knowledge about the IASB's development. Thomas Frank, Katja Walther, and Robert Müller provided great help in putting together much of this book. Special thanks go to Sylvia Pichorner, who meticulously went through many pages numerous times to correct spelling and check citations. In writing this book, Stephan Elkins provided invaluable help with translating many text passages and language-editing the entire manuscript. I am also indebted to the Social Science Research Center for its financial support in making this publication possible. Most importantly, I would like to thank Maren and Jakob for their support during many long days, and for reminding me of the truly valuable things in life.

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1. Introduction: the globalization of accounting

The financial crisis of 2007–09 is frequently referred to as the most drastic and consequential episode in more than two generations. Housing prices plummeted, banks were taken over or went bankrupt, and production declined in many countries. Many people lost their jobs and sweeping austerity measures are likely to affect public spending for years to come. The financial sector was hit particularly hard. Some institutions took excessive risks and experimented with complex and opaque products they were ill-equipped to handle. The interbank market dried up, and even bank runs made front-page news. Vibrant discussions of the reasons soon emerged and brought to prominence an aspect of financial market regulation that had previously been discussed only among experts: Accounting rules now became the object of heated debate. Off-balance sheet accounting and the procyclical characteristics of fair value accounting were quickly identified as one important cause of the financial crisis. Moreover, more than just accounting rules were criticized. The G20 questioned the governance structures for standard setting in international accounting and called for immediate actions. In particular, it asked the standardization body to review its membership, to enhance transparency, and to ensure appropriate relationships with public authorities (G20, 2008, p. 6). Political reactions to the financial crisis moved accounting standards and transnational standardization bodies into a spotlight that they had successfully avoided for decades.

For most of the time, accounting regulation had been the business of practitioners and experts. Once a federation of national associations, today's International Accounting Standards Board (IASB) is a private standard-setting body with more than 100 employees and an annual budget exceeding £12 million sterling. Since 1973 it has been in charge of producing a coherent set of international standards. Over the years, the IASB has been asked by many jurisdictions to develop standards for listed companies filing financial statements. Even before the financial crisis, criticism had mounted and the IASB's private governance structure was challenged despite increasing diffusion of its standards. However, the heated debate over IASB and its standards can also be taken as a sign of the organization's relevance in regulating cross-border capitalism. It is this core position and the economic and political implications of private standardization that make the IASB a worthwhile object of study. As will become clear, there are no simple explanations for the rise and dominance of the IASB and its standards today. Instead, I present a comprehensive and historically informed approach to understanding organizational developments, rule setting procedures, and dominant actor coalitions.

IASB's uniqueness among international standard setters is widely acknowledged. Out of the 12 key standards identified by the Financial Stability Board (FSB) as ensuring a stable and well-functioning financial system, only those relating to accounting and auditing are set by private bodies (FSB, 2011). Other rules are drafted by intergovernmental organizations, such as the International Monetary Fund (IMF) or IOSCO, the International Organization of Securities Commissions. In accounting and auditing, however, professional actors dominate. Auditing standards are set by the International Federation of Accountants (IFAC), the accountancy profession's global organization. In accounting, the IASB is the center of a regulatory network orchestrating a multitude of actors.

The distinct features of international accounting standardization have increasingly become an object of academic interest. Different interpretations are placed on the emergence of the IASB and the contribution of this private standard-setting body to the harmonization of rules for financial reporting. A more detailed discussion of different approaches follows in Chapter 2, but a number of strands stand out. First and foremost, there are functionalist accounts that argue in favor of a coherent set of standards as a necessary condition for cross-border capital mobility. These perspectives are prominent among accounting studies where much of the debate centers around accounting standards as a means of facilitating (or impeding) information flows between firms and providers of capital. Frequently, the IASB and its standards are considered to be a good, under current conditions perhaps even optimal, solution to overcoming information asymmetries. The organization's capital-market orientation and its close liaison with business are praised as a lean and responsive way of practical problem-solving. Catering to the information needs of capital market actors and allowing them to engage with a private regulatory body are frequently interpreted as functionally adequate means of providing corporate information (cf. Nobes and Parker, 1985, 2004; Sunder, 2002). Political approaches have placed accounting standardization in the wider ambit of regulating global capitalism. The IASB and its success are interpreted as a function of US American financial market dominance (Simmons, 2001) or as a compromise of transatlantic bargaining processes (Posner, 2010). Complementary works on private authority have outlined how professional actors and business interests have concurred in the establishment of a private self-regulatory regime, drawing on specialized expertise and catering largely to the interests of globally active businesses (Porter, 2005; Nölke and Perry, 2007).

All of these perspectives have some merit and contribute to understanding the IASB's role in global financial market regulation. However, they only touch upon selected aspects of private global accounting regulation and often fail to give a coherent and discrete explanation of the IASB's emergence and the diffusion of its rules. What is missing so far is a broad analysis of historical developments and organizational characteristics bringing together the approaches mentioned above. This book intends to give such a comprehensive account linking different theoretical perspectives and discussing the sociological underpinnings. It presents a reconstruction of the developments in private accounting regulation at the transnational level. In particular, the book focuses on organizational characteristics to capture the complexity of this process. Furthermore, the case of international accounting regulation permits us to derive lessons about processes of transnational institution building in general. The long-term perspective applied here reveals mechanisms of institution building beyond the nation state, which is characterized by private and public actors from numerous jurisdictions struggling over rules and procedures.

The IASB and its transformation over more than three decades are at the heart of this book. It considers the actors' motives and the conditions they face in establishing and shaping rule setting beyond the nation state. In particular, I answer the following questions in this book: How can the emergence of a private regulator be characterized and explained? What are the mechanisms underlying transnational standardization in accounting? Who are the core actors, and how did they influence developments? Finally, what more general conclusions can be drawn to inform future research into financial market regulation, with particular regard to transnational institution building?

In the remainder of this chapter, I will give a brief introduction to the IASB and its normative foundations, outline the content of the book, provide some relevant background information on the societal relevance of accounting standardization, and discuss the global diffusion of standards.

1.1 CONTENT OF THE BOOK

Attempts at standardizing accounting rules started decades ago. In most cases, professionals and their associations played a crucial role. Today's

IASB is built on these efforts, making it a unique case of a private rule-setting organization that develops quasi-binding standards for the world's capital markets. Over recent decades, the IASB has developed a broad set of standards to foster the global harmonization of financial market information. Its standards, known as International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS), are used by thousands of corporations in more than 100 countries when preparing financial reports. What is now the IASB was founded in the early 1970s and the organization has been an object of controversy ever since.[1] In addition to the organizational design, the content of standards has also been disputed even though market logic has always played a prominent role. Today, a clear-cut orientation toward market values, in particular fair value accounting, dominates. In practice, market prices are interpreted as 'fair values,' triggering prompt adjustments in financial reports, thus introducing an element of procyclicality into corporate statements.

The IASB and its embeddedness in a wider, transnational regulatory network are at the heart of this book. Not only has the content of rules been contested, the organizational structure and composition of its decision-making bodies have also been the object of bargaining and interest group politics. As a result of these interactions, the IASB is more than a transnational arena for standard setting. Over time, it has acquired the properties of an actor in its own right and has turned into a core player in regulating accounting at the transnational level. In this analysis, I will take up earlier work, which has pointed out the importance of interests in standard setting, and go one step further to not only provide a detailed characterization of the organization's current configuration but also shed light on the political character of organizational structures and standard setting procedures and elucidate the contested nature of accounting regulation. Demonstrating the political nature of the standard setting endeavor and its organizational representation is the main goal of the book.

Studying how actors shape rule setting beyond the nation state is central to this longitudinal analysis. A process perspective allows us to grasp the dynamics of transnational institution building and also take into account unintended consequences, paradoxical effects, and power struggles. In the final chapter, I will propose an institutionalist interpretation of the empirical findings, arguing that a transnational regulatory path has emerged that is dominated by the IASB and certain actor constellations. Hence, a precise characterization of these constellations is one key aspect of the study. Some of the positions within the wider regulatory network are predefined by the IASB's constitution, which puts particular emphasis on the expertise shared by accounting practitioners. Professional competence and practical experience are key qualifications expected of the members of the organization's board who are engaged in standard setting, as well as of the foundation's trustees tasked with overseeing standardization activities.

Accounting standards are predominantly concerned with offering a framework that allows corporate information to be translated into numbers. Measurable and calculable constructs give an indication of a company's economic performance. At the firm level, the availability of comparable, reliable, and meaningful financial information is a key requisite to attract external investment. Multinational corporations use financial reports to frame performance according to numerical logics and to address the information needs of third parties. Publishing annual reports, however, is more than a legal requirement. It also permits the presenting of financial and other information to specifically address the needs of shareholders and other capital providers. In addition, the needs of other stakeholders, tax authorities, and other interested parties are addressed. Listed corporations therefore use financial reporting to paint a picture of the organization's activities, channeling specific information about past and present affairs as well as giving an indication of future objectives. Numbers play a crucial part in defining an organization's image. This makes financial statements a contested terrain and points to the political nature of standards, which are at the heart of financial reporting and auditing.

Although discussions about nonfinancial and future-oriented reporting are on the rise (cf. Chahed, 2011), most attention is still given to the numerical composition of the financial reporting framework. At the national level, the rules for drafting, presenting, and auditing annual reports were once commonly shaped in an interplay of professional actors, academics, accounting practitioners, lawmakers, and business interest groups. Financial statements used to reflect historical traditions, cultural backgrounds, socioeconomic conditions, and the balance of political power. Today, the increasing role of the IASB contributes to detaching accounting standardization from existing national traditions. While implementation and enforcement largely remain local affairs, the development of quasi-binding standards is orchestrated transnationally by the IASB. To a considerable degree, the *locus* of rule making has shifted, and standardization has become disembedded and detached from long-standing national contexts.

Much of today's interest in the IASB is rooted in this unique setup of accounting standardization. Its effective consultation procedures, the assemblage of renowned individuals and organizations, and a self-confident display of professional expertise make the organization a "successful" case of private cross-border rule-making. As will be shown in Chapter 3, a historical perspective reveals that for more than 25 years the

IASB's prospects were unclear. Developments were blocked by opposing interests and a lack of recognition by third parties impeded significant progress. For years, the absence of public authority was an impediment to effective transnational regulation. A closer look suggests that, for a considerable time, the emergence of a private rule-setting arrangement seemed unlikely. Consequently, the fact that the IASB has emerged as the dominant standard setter not only calls for empirical explanation but also provides a vantage point for theoretical considerations. Understanding how IASB became a "strategic networker, seeking to entrench its standards in the operations of other key actors" (Braithwaite and Drahos, 2000, p. 121) will contribute to getting a better picture of transnational self-regulation and explaining institution building beyond the nation state. The book explicitly links norms, organizational structures, and actor constellations to reconstruct how a coalition of actors established, reformed, and solidified a private standard-setting organization that today sets the tone in the field of accounting regulation. Conceptually, the book provides generalizable findings with regard to the mechanisms of transnational institution building.

The book is structured as follows: Chapter 1 provides an introductory overview of the globalization of accounting. It also points out the societal dimensions of accounting rules and discusses the global spread of IAS/IFRS. Chapter 2 gives an outline of central theoretical approaches to explain transnational accounting standardization and presents the research design and methodology. Chapter 3 gives a condensed account of the IASB's origins and early history, underlining that contest over the means and goals of the organization has been prevalent from the beginning. By putting the private regulatory arrangements into historical context, I indicate how the IASB managed to outcompete public endeavors to make international rules by drawing on anti-statist professionalism. Chapter 4 analyzes changes in the normative content of accounting standards, in particular the increasing capital-market orientation embodied in fair value accounting. It becomes clear that accounting standards are both a result of and a further force driving financialized global capitalism. Chapter 5 reconstructs the organizational developments of the IASB and uncovers how the privately run standard setter established procedures to consult with interested parties without handing over too much influence to outsiders. The analysis shows how democratic accountability was subordinated to the effectiveness of expertise-based standardization largely driven by—private and public—Anglo-American actors. Chapter 6 complements the organizational dimension with an analysis of the dominant individuals and the most influential organizations in the wider international standardization network. Accountants and globally active auditing firms accompanied by national regulators and selected international organizations dominate standard setting. Surprisingly, users of financial statements, by many considered to be the prime addressees of those statements, do not play a significant role. Finally, Chapter 7 sums up the empirical findings and relates them to the theoretical debates on transnational institution building, interpreting the developments as the emergence of a transnational regulatory path.

In a nutshell, the book argues that standardization is much more than a "technical" affair orchestrated by a few dedicated individuals striving to find the one best solution in international standardization. Instead, the politics of accounting regulation shows that economic globalization is constructed by many actors and succeeds when carefully linking the normative content of standards to organizational structures, consultation procedures, and stable actor coalitions. This explains how, even in times of financial crisis, the IASB displays remarkable institutional stability and continues to shape financial reporting practices worldwide.

1.2 THE SOCIETAL RELEVANCE OF FINANCIAL REPORTING: THE POLITICS OF ACCOUNTING REGULATION

The objective of publishing financial statements is to give an account of an entity's financial and economic activities. States, nonprofit foundations, cooperatives, and profit-making organizations all issue financial and nonfinancial information to inform shareholders, stakeholders, and other third parties. Organizations use formal annual reports to comply with legal requirements but also to conform to more general norms of accountability, reliability, and validity. For corporations, proper book keeping and transparent reporting are key elements in any strategy to disseminate information regarding their current state and future prospects. Financial statements serve to inform market actors and public authorities and assist them in making decisions, such as buying or selling shares, granting loans or purchasing products. Individuals might base their job search on the information published while tax authorities draw on accounts to levy taxes. The information function of financial statements, however, is contextualized in time and space and subject to change.

Depending on the national context and the particular legal status of a corporation, the groups to which financial reporting information is addressed will vary: In Anglo-American countries, shareholders and investors are considered the most relevant target group for the financial statements issued by listed companies. In continental Europe, annual reports also serve tax authorities, which have traditionally used them to determine the taxes of profit and nonprofit entities. Over time, the orientation toward anonymous outsiders, namely the providers of capital, has increased in many jurisdictions. This is symbolized by a shift in vocabulary from "accounting" to "financial reporting." While the former stresses the recording, classifying, and summarizing of financial transactions and events, reporting puts more emphasis on formally presenting corporate affairs to investors. The preparation of financial statements encompasses both accounting for past periods and depicting reasonable expectations for the future. As well as practitioners, many accounting scholars suggest or at least imply that the information disclosed in financial statements is an "objective" representation of a company's economic situation. Such a positivist understanding dominates institutional economics, particularly transaction cost and positive accounting theory. Interpretative accounting theory, institutionalist research, and radical accounting theory, on the other hand, have challenged this view. Most of the literature on accounting in the fields of sociology and political economy is in line with the latter approaches and rejects assumptions that economic reality can be objectifiable, or easily transposed into numbers. Instead, drafting a financial report is a constructive act in which numerical and other data are assembled by both following and interpreting existing accounting standards. This latter view is the basis of this book, which shares the assumptions of post-positivist theories.

More critical approaches also allow consideration of the distributive effects induced by accounting standards. Today, the most pertinent aspect of financial statements is to determine a corporation's profit or loss, which in turn serves as the basis for determining dividends and management remuneration. Corporate results are also processed by financial market actors and influence credit lines, ratings, and the stock market valuation of the reporting entity. These distributive effects make accounting standards a worthwhile target of different interest groups: Whenever national or international standard-setting bodies

> formulate accounting rules, governmental and quasi-governmental agencies, companies preparing financial statements, financial analysts and investment advisors, auditors and tax advisors, employees' representatives, accounting professors, lawyers, and other affected parties all make their influence felt. They propose changes or defend the status quo, comment on suggestions of others, wield knowledge, money, and other instruments of power—all this to promote accounting rules that are as favourable to them as possible. (Ordelheide, 2004, pp. 271ff.)

Both at the national and international level, lobbying activities have been analyzed as part of an overt conflict over the precise wording of particular