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ASB's Standard-Setting Process

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THE GRASSHOPPERS AND THE GREAT CATTLE

AN EXPLORATION OF PARTICIPATION IN THE ASB'S STANDARD-SETTING PROCESS

ABSTRACT

This paper presents the results of a research study of participation in the Accounting Standards Board's ('the ASB') standard setting processes. It replicates studies of a similar nature carried out in the US and Australia or in specific contexts (e.g. Operating and Financial Review) in the UK. The study considers the 1,519 responses to the ASB's proposals for accounting standards. Consistent with the findings of other studies, the study finds that there is a high level of preparer participation in the ASB's consultation process. Drawing on Positive Accounting Theory to develop its hypotheses, the paper then examines the characteristics of the preparer corporations which formally lobbied the ASB. The research evidence supports the hypotheses that those firms who become involved in the lobbying process tend to be larger and more highly geared than non-lobbying firms. The paper concludes by considering the implications of these findings in the light of the ASB's objectives.

Because half a dozen grasshoppers under a fern make the field ring with their importunate chink, whilst thousands of great cattle repose beneath the shadow of the British oak, chew the cud and are silent, pray do not imagine that those who make the noise are the only inhabitants of the field.

Edmund Burke - Reflections on the Revolution in France (1790)

1. INTRODUCTION

The Accounting Standards Board ('the ASB') was established in 1990. Among its objectives is improvement of standards of financial accounting and reporting for the benefit of users, preparers and auditors of financial information (ASB, 1991). The Board sets out inter alia to 'determine what should be incorporated in accounting standards based on research, public consultation and careful deliberation about the usefulness of the resulting information' (ASB, 1991, p. 2). This paper examines the characteristics of those who formally involved themselves in the standard-setting process of the ASB by making submissions regarding its proposals for accounting standards. In doing so, the paper contributes to a view of the public consultation that fashions accounting standards and explores the involvement of the different parties who are expected to benefit from accounting standards.

The paper is in four main sections. The first of these, Section 2, explores the nature of power and participation in the standard-setting process, focusing in particular on the hypotheses and findings of other studies in the accounting literature. Several studies have found a preponderance of preparers among the participants in the standard setting process. In the light of other research and the stated aims of the ASB the paper analyses the participation of various interest groups in the standard-setting process of the ASB since its inception.

In Section 3, the paper explores motivations for participation and non-participation in the standard setting process. This exploration confirms the preponderance of preparer involvement in the ASB's standard-setting process. In the light of this finding, Section 4 examines the participation of preparers in the context of the hypotheses of Positive Accounting Theory regarding firm size and gearing. The paper concludes with a brief discussion of the implications of the research in Section 5.

2. CONCEPTS OF POWER AND ACCOUNTING STANDARD SETTING

There are broadly two contrasting views on the nature of accounting standard setting: the technical view and the political view. The technical view

sees the problem of choice as essentially one of identifying 'best' accounting practice . . . which can be solved by the development and application of technical rules or concepts of accounting. (Taylor and Turley, 1986, p. 68)

The political view, on the other hand, argues that the best solution varies from person to person and from group to group. The best alternative is, therefore, a relative concept (Kam, 1990) and often depends on the way that proposed standards affect personal interests (Mautz, 1974). Under the political view, policy decisions represent choices between conflicting interests which might be better served by different practices. Hence, the setting of accounting standards is a political activity. The consequences of such activity involve resource allocation and re-distribution of wealth between the constituents or stakeholders of accounting information.

Political choices might not, however, be neutral. Any analysis of political choices must also consider issues of power (Cooper and Sherer, 1984) because, even in ostensibly democratic societies, certain groups may wield disproportionate amounts of power and influence. Similarly rule-makers may unduly favour particular groups (Underdown and Taylor, 1986, p. 17).

This paper explores the exercise of power in the ASB's standard-setting process in the context of what Lukes (1974) terms the one-dimensional view of power. The one-dimensional view is 'a focus on behaviour in the making of decisions on issues over which there is an observable conflict of (subjective) interests, seen as express policy preferences, revealed by political participation' (Lukes, 1974, p. 15). This view of power is primarily based on the writings of Dahl (1961), Polsby (1963, 1968), Merelman (1968) and Wolfinger (1971).

Previous accounting studies have traditionally been based on a one-dimensional view of power. Submissions on discussion memoranda and exposure drafts are the most observable form of lobbying and these have formed the main basis for previous lobbying research (Tutticci, Dunstan and Holmes, 1994). Walker and Robinson (1993) document the publication of over twenty such studies since 1980.

These studies generally examine the frequency of responses to proposed accounting standards ('frequency studies') and the extent to which standard setters align their accounting standards with the various views expressed ('alignment studies'). The written submissions on discussion memoranda and exposure drafts of corporations are used as evidence of such lobbying.

Many studies have examined the frequency of submissions made by different interest groups. Weetman, Davie and Collins (1996, p. 62) comment that the 'common features' of such studies are that 'corporate respondents (preparers of accounts) comprise from one-third to a half of all respondents by number' and that responses from users of financial statements are generally uncommon.

Studies concerning the Financial Accounting Standards Board ('the FASB') have found that 50 per cent of all written responses come from preparers of financial statements, while less than 10 per cent come from users (Miller, 1985). An analysis of submissions on 30 randomly selected Statements of Financial Accounting Standards ('SFASs') by Mezas and Chung (1989) in the US found that preparers of financial statements write more letters of comment than all other groups combined. Tandy and Wilburn (1992) found that 57.9 per cent of all submissions received on the FASB's first 100 statements came from the preparer group. This figure comprises 60.7 per cent of all individual and 34.9 per cent of representative body responses. Academic participation was 2.5 per cent while submissions directly representing users amounted to only 1.79 per cent.

The paucity of user responses in the written submissions to standard setting bodies has been observed by many studies, for example, Sutton (1984), Tutticci et al., (1994) and Ó hÓgartaigh and Reilly (1997). Armstrong (1977) and Beresford (1991) note that the user community have been minimal contributors to the process. Weetman et al., (1994, 1996) extend these findings to the UK specifically in the context of the ASB's Operating and Financial Review. Jack (1991) also notes that the debate on accounting practice has been characterised by the lack of significant contributions from those whose interests are most directly involved, the users of financial statements.

This exploratory research does not focus on the group(s), if any, to which the ASB may align itself. It belongs clearly within the ambit of frequency studies as it sets out to identify, initially, the participants in the ASB's standard-setting process. Having identified the main participants in the process, it then goes on to explore the characteristics of such participants. Such a frequency study is however a preamble to a potential study (or studies) of alignment. If frequency of lobbying by any one interest group is established, a natural extension is the examination of whether the ASB's accounting standards are aligned to the views of that interest group. Furthermore, frequency of involvement, if supported, may create perceptions of alignment. Therefore, the study while looking exclusively at the issue of frequency of participation contributes to the establishment of a bridgehead for the potentially more difficult study of alignment.

3. PARTICIPATION IN THE ASBs STANDARD-SETTING PROCESS

The first element of this research attempts to ascertain which interest groups participate in the standard setting process. The research focuses on an empirical analysis of the written submissions prepared in response to Discussion Papers ('DPs') and Financial Reporting Exposure Drafts ('FREDs') published by the ASB.

This element of the research examines the number of submissions made to the ASB since its inception to the public hearings on goodwill to October 1995 . Submissions on amendments to ASB standards proposed in FREDs 2, 5 and 9 were excluded. Thus the submissions of the 1,519 respondents on 21 of the ASB's projects were recorded.

To ascertain the participation of each interest group in the standard setting process, responses are classified into 11 categories, according to the nature of their interest in financial reporting. In assessing the affiliation of respondents, consideration was given to any explicit statement which identified the capacity in which the submission was made and also to the general tone of the submission.

A summary of results is presented in Table 1. Preparers of financial statements accounted for 41 per cent of total responses. This figure is significantly higher than the second most frequent respondent, the accountancy firms, which contributed 21 per cent of responses. The lowest responses came from government, the legal community, academia and the users of financial statements. (a chi square test

suggests that the number of responses from preparers of financial statements are significantly greater ($\chi^2=2429.3$, d.f. =10) at a 99% level of confidence.)

Table 1: Constituent involvement in the ASB's standard setting process

Group	Number	%
Preparers of accounts	617	41%
Representative bodies which represent preparers	112	7%
Accountancy firms	319	21%
Accountancy bodies	146	10%
Mixed preparer/accountancy	3	-
Mixed preparer/user	39	3%
Users	124	8%
Academia	52	3%
Government	10	1%
Law	20	1%
Individuals/affiliation not clear	77	5%
TOTAL	1,519	100%

The results support the perception that preparers dominate the formal lobbying process while users of financial statements present their views only infrequently. Preparers and their representatives accounted for 48 per cent of total responses while users of financial statements only submitted 8 per cent of responses.

Those users that did submit responses tended to be the suppliers of capital. User respondents comprised investment companies, pension funds, venture capitalists, banks, building societies, industrial development boards and tax authorities. There were no responses from trade unions, consumer associations or other public representative bodies.

It might be expected that the individuals would comprise a majority of financial statement users. However, only two respondents specifically identified themselves as users (these are included in the user group) while 13 individuals were identified as accountants.

4. CHARACTERISTICS OF PREPARER PARTICIPATION

The preponderance of preparer involvement established in this research and elsewhere leads to further analysis of the characteristics of those who felt moved to become involved in the ASB's standard-setting process (i.e. predominantly preparers). This section examines the characteristics of the preparer participants in the light of these assertions and other suggestions in the literature.

Weetman et. al. (1996, p. 74) find evidence that analysts do not expect to be influential in the lobbying process since they believe that 'the preparers of accounts hold the key to consensus'. The perceived incentives for preparers of accounts to engage in lobbying activity are great. Participation choice studies explicitly recognise the economic consequences of accounting standards. Preparers of financial statements are more likely to lobby than users because they generally have more to lose than users have (Bryant and Mahaney, 1981; Sutton, 1984). The majority of users hold well-diversified asset portfolios (for example, equities / cash / bonds / currencies / derivatives). On the other hand, lack of diversification renders the preparer more sensitive to any adverse economic consequences associated with a proposed standard. Sunder (1980) points out that the cost of switching investments is still less for a large undiversified investor than it would be for a company to change its line of business. Schalow (1995) comments that most of these participation studies are conducted under the auspices of positive accounting theory (PAT).

4.1. Positive Accounting Theory

Much of the origins and development of PAT is attributed to the work of Watts and Zimmerman (1978, 1979, 1986, 1990). Watts and Zimmerman assume that individuals maximise their own expected utilities and that they are innovative and creative in doing so (Watts, 1977; Watts and Zimmerman, 1978). This is the key behavioural assumption of PAT and in this way PAT builds upon the principal-agent analysis of Jensen and Meckling (1976). The implication of this assumption is that management lobbies on accounting standards in its own self-interest.

Watts and Zimmerman adopt a contracting perspective to determine the factors that influence a manager's decision to lobby on accounting issues. Many of a firm's contracts are defined in terms of financial reporting information. The form of financial accounting disclosure has the potential to affect some of these contracts, for example, capital adequacy ratios, borrowing covenants and management

compensation schemes. This results in an economic impact on the parties involved. It is logical to presume that those affected will mobilise their forces to encourage the promulgation of statements favourable to them (Watts and Zimmerman, 1978; Hope and Gray, 1982; Watts and Zimmerman, 1986).

Specifically, PAT concludes that there are empirical regularities between a firm's decision to lobby on a proposed accounting standard and properties of its debt contracts, management compensation contracts and its political visibility. These are discussed below.

4.1.1 Firm size

The political cost hypothesis states that lobbying companies are, on average, larger than non-lobbying companies. Size is a proxy variable for political visibility (Pacecca, 1995). Accounting standards which increase a large firm's reported earnings have economic consequences in that they increase political visibility. This can impact on a company's bookkeeping and regulatory costs. It may also lead to increased taxes and wage claims, a reduction in subsidies granted or an increased scrutiny by monopolies and mergers commissions. Mansfield (1962) also states that increased political visibility may result in increased competition arising from new entrants attracted by the accounting profit of the industry.

Numerous empirical studies support the political cost hypothesis, for example, Hagerman and Zmijewski, (1979); Bowen, Lacey and Noreen (1981) and Zmijewski and Hagerman (1981). Sutton (1984) uses a theoretical framework to conclude that large producers are more likely to lobby than small producers. This framework is based on the suggestion by Downs (1957) that size determines the cost of lobbying relative to its benefits. Francis (1987) uses net sales as a proxy for firm size and Saemann (1987) uses total sales and book value of assets. Both conclude that firm size was a significant factor in the decision of firms to lobby on the FASB's Preliminary Views on 'Employers' Accounting for Pensions and Other Post Employment Benefits'.

Morris (1986) and Gavens, Carnegie and Gibson (1989) found similar results for Australian companies.

4.1.2 Debt / equity ratio

The debt/equity hypothesis posits that lobbying firms tend to have a higher debt/equity ratio than non-lobbying firms. The debt/equity ratio is taken as a proxy for the existence and tightness of a firm's debt covenants (Kalay, 1982).

The tighter a firm's debt covenant, the greater the probability of a covenant violation (Watts and Zimmerman, 1990). Covenant violation results in re-negotiation of debt covenants which give rise to contracting costs. Similarly future capital may become more expensive to obtain. Higher than normal gearing ratios may also result in a restriction on the ability of the firm to raise new capital or a fall in stock or bond ratings.

Again, numerous studies support this hypothesis. For example, in an analysis of Statement of Financial Accounting Standards (SFAS) 8 issued by the FASB, Griffin (1982) confirmed that lobbying companies tended to be larger and more highly geared than non-lobbying companies. The determinants of lobbying behaviour according to Dhaliwal (1982) include firm size and capital structure. Christie (1990) concluded that firm leverage was a significant variable in the decision of managers to lobby accounting standards boards.

Positive accounting research and studies deriving from such research provide some evidence of a systematic association between the corporate decision to lobby and the variables that proxy for economic incentives including firm size, gearing and bonus plans.

4.2 Research Method

This paper seeks to ascertain the relevance of these variables, specifically those relating to firm size and gearing, to the ASB. Such a study involves a comprehensive empirical analysis of the formal submissions made to the ASB on their various discussion memoranda. It also contains an analysis of the characteristics of the corporate respondents in an attempt to discover a link between these characteristics and their propensity to become involved in the standard setting process. Drawing on previous studies in the area as discussed above, the research hypotheses may be expressed as follows:

H1 : The larger the company, as measured by its average turnover, the greater the probability that the company submitted a written response to the ASB.

H2 : The greater the debt to equity ratio of a company, the greater the probability that the company submitted a written response to the ASB.

Hence, the objective of this study is to determine if lobbying firms tend to be larger and more highly geared than their non-lobbying counterparts.

This necessitates the use of variables which represent size and debt covenants. Company size is used as a proxy for political costs and company turnover is used to measure firm size. This is the approach adopted by Francis (1987), Saemann (1987) and Schalow (1995).

A company's gearing ratio is taken as the proxy for the closeness of the observed gearing ratio to the maximum ratio prescribed in a contract to raise long-term debt (after Dhaliwal (1982) and Deakin (1989)). This, in turn, is taken as a proxy for the expected value of the costs which arise from any restrictions imposed upon the company under its debt contracts.

The analysis is based on financial information obtained from Dun & Bradstreet's Corporate Financial Performance: Britain's top 50,000 companies (Dun & Bradstreet, 1994, Vols 1 and 2) for the years 1991 to 1994 inclusive.

Therefore, a firm was included in the study if it

- was UK incorporated,
- submitted at least one written response to an ASB discussion paper or exposure draft issued between 1991 and 1994 (as this is the period for which the Dun & Bradstreet financial information is used), if this submission became part of the public record (these ASB documents are listed in Table 2: these are a subset of the ASB projects noted earlier: ASB proposals issued after 1994 are excluded as the period of this study is 1991 to 1994), and,
- if the company formed part of the Times 1000 1995 compiled by Extel Financial (1994).

Table 2 - ASB statements included in study of preparer involvement

ASB STATEMENT	ISSUE DATE
Statement of Principles - Chapters 1 and 2	July 1991
FRED 1	December 1991
Statement of Principles - Chapter 6	December 1991
DP - Accounting for Capital Instruments	December 1991
Operating and Financial Review (OFR)	April 1992
FRED 3	December 1992
FRED 4	February 1993
DP - Role of Valuation in Financial Reporting	March 1993
DP - Fair Values in Acquisition Accounting	April 1993
FRED 6	May 1993
DP - Goodwill	December 1993
FRED 7	December 1993
FRED 8	March 1994
Review of FRS 1	June 1994
DP - Associates and Joint Ventures	July 1994
Consultative Document on Exemption of Small Companies	November 1994

A total of 108 firms fulfilled all three conditions. An average of each company's turnover and gearing ratio for three financial years covering the time period 1991 to 1994 was calculated. Gearing is defined as long-term debt divided by long-term debt plus shareholders' funds and is expressed as a percentage. Long-term debt is debt due for payment after more than one year.

To determine the similarity of turnover and gearing characteristics of non-lobbyists, a sample of 108 firms that did not submit any responses to the ASB were selected haphazardly from the Times 1000 list for 1995. Similar turnover and gearing figures were also obtained for these firms.

4.3 Research results

The 108 companies that lobbied the ASB were compared with the sample of non-lobbyists. The results are displayed in Table 3.

Table 3: Mean turnover and gearing of lobbyists / non-lobbyists

	Lobbyists	Non-Lobbyists
Mean Turnover	£2,808,153,000	£354,984,000
Gearing	38.34%	23.68%

The mean and standard deviation of each sample was calculated. As can be seen from Table 3, the average turnover of firms who lobbied the ASB was approximately ST£2.808 billion compared to ST£355 million for non-lobbyists. Lobbyists also tended to more highly geared. The average gearing ratio for lobbyists was 38.34% and 23.68% for non-lobbyists.

- In order to determine the significance of the differences between the two means, a two-tailed hypothesis test was performed. The test returns t-scores of 6.73 and 5.34 for sales and gearing respectively. Both of these figures are significant at a 99 per cent level of confidence. The evidence therefore supports the hypotheses that lobbyists to the ASB tend to be larger and more highly geared than non-lobbyists.

If ranking in the Times 1000 (rather than turnover) is used as a measure of size, corporate responses comprised 134 members of the Times 1000 companies for 1995 (Extel Financial, 1994). This represents a 13.4 per cent relative response rate. Out of the top 50,000 companies in the UK, only 214 companies responded to the ASB. This amounts to a 0.428 per cent relative response. These findings further suggest that a higher percentage of those corporations that become part of the ASB's lobbying process are larger firms.

Most corporate respondents appeared to participate in the ASB's standard setting process on a selective basis. For example, only 2% (or 13) of corporate respondents (totalling 617) responded to more than 10 of the ASB's proposals. Most responses were to only one of the proposals with the Discussion Paper Accounting for Tax attracting most response. This is consistent with the results of research by Brown (1981). Brown's US-based study found that only 27 respondents commented on at least seven of the nine FASB projects analysed. The 27 respondents consisted of the Big 8 public accounting firms, nine industrial firms, nine representative organisations and one government agency. This is also consistent with the

suggestion that the economic consequences of standards will affect some firms more than others and this effect will vary from standard to standard.

Table 4: Reporting entities / preparers becoming involved more than 10 times in the standard setting process

Reporting entity	No. of responses (max. 21)
British Gas plc	16
Grand Metropolitan plc	16
Guinness plc	16
BAT Industries plc	15
Boots Company plc	13
British Petroleum plc	11
Cadbury Schweppes plc	11
ICI	11
Post Office	11
Royal Dutch / Shell Group	11
Sedgwick Group plc	11
Unilever	11
SmithKline Beecham plc	10

Furthermore, Table 4 lists the individuals or organisations who responded to ten or more of the ASB's statements. These respondents comprise thirteen corporations (5.3% of the 245 preparers of financial statements who became formally involved at least once in the standard setting process). With the exception of Sedgwick Group plc, all corporations are ranked in the top 50 of the Times 1000. This would further suggest that large firms lobby more consistently than smaller firms.

These findings are consistent with those elsewhere in the literature. As discussed earlier, the central propositions of PAT are that those firms with higher turnover have a higher visibility and that the benefits of intervention for such reporting entities outweigh the costs. Firm size in this instance is taken as a proxy for political costs. Similarly debt covenants are assumed to be of more concern for those firms with higher gearing and, as a result, such firms are assumed to have a greater interest in the effects of accounting standards than firms which have a lower gearing. The

results confirm both of these propositions in a similar manner to the results of, for example, Francis (1987), Tutticci et al. (1994) and Pacecca (1995).

The potential limitations of this research include its subjectivity and its one-dimensional focus. An important limitation of studies such as this is the subjectivity involved in the classification of responses. Furthermore, there may be overlap between a respondent's role. Many respondents may be users (for example for credit and / or investment decisions) as well as preparers of financial statements. They are classified in this study in according to the group to which they primarily belong.

The research focuses on one dimension of lobbying: formal written submissions on discussion memoranda. It thereby excludes other methods of lobbying from the analysis. The notion of 'participation' in this instance comprises a formal submission to the ASB. This usage is consistent with that of other studies such as Weetman et al. (1996), Schalow (1995) and Francis (1987). However, written submissions to accounting standards boards represent a relatively late and insignificant part of the overall political process. Earlier stages include contests over the composition of the standards boards themselves and the overall structure of regulatory arrangements (Walker and Robinson, 1993).

Accounting data are used in the assessment of firm size and gearing. Such data must be treated cautiously as they are accompanied by the inherent limitations of accounting data including historical cost and potential differences in accounting policies. There is little reason to believe however in the context of this study that the strong results obtained would be undermined by the effect of these limitations in accounting data.

5. CONCLUSION

This paper presents evidence to confirm that users of financial statements do not participate to any great extent in the UK standard setting process. Their presence has been overshadowed by the preparers of financial statements who, together with their representatives, account for almost half of all formal submissions made to the ASB documents reviewed in this study.

The study examined the characteristics of these respondents, using PAT as a research framework. It was found that lobbying corporations in the UK tend to be larger and more highly geared than non-lobbying corporations. This implies that managers are, in fact, more concerned with the impact of accounting standards on political costs and debt-covenants and, hence, the economic consequences of the proposed standard to their firm.

The implications of these findings for the ASB are that it may be hearing only a particular view of its proposals for accounting standards, a view that is tempered by the nature of its respondents. The high level of preparer participation in the standard setting process also suggests that the ASB may be hearing more about the cost of implementation of accounting standards to preparers than about their benefits to users. Its objective of fashioning standards for the benefit of users, preparers and auditors of financial information (ASB, 1991) in the heat of public consultation may be circumscribed in the light of the limited 'public' which demands access to its deliberations.

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