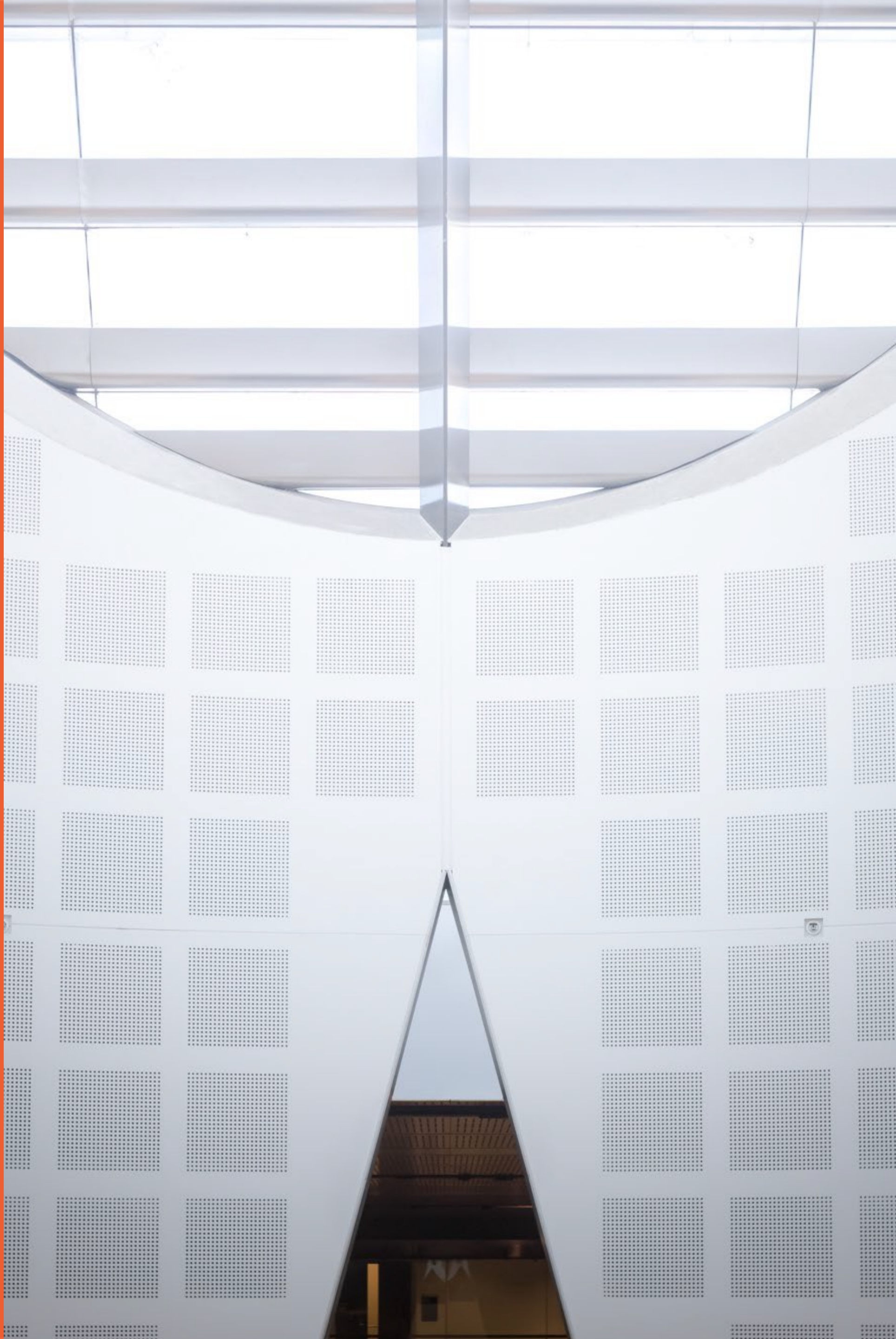
ACCT 6002

Political Lobbying and Standard-Setting

THE UNIVERSITY OF SYDNEY

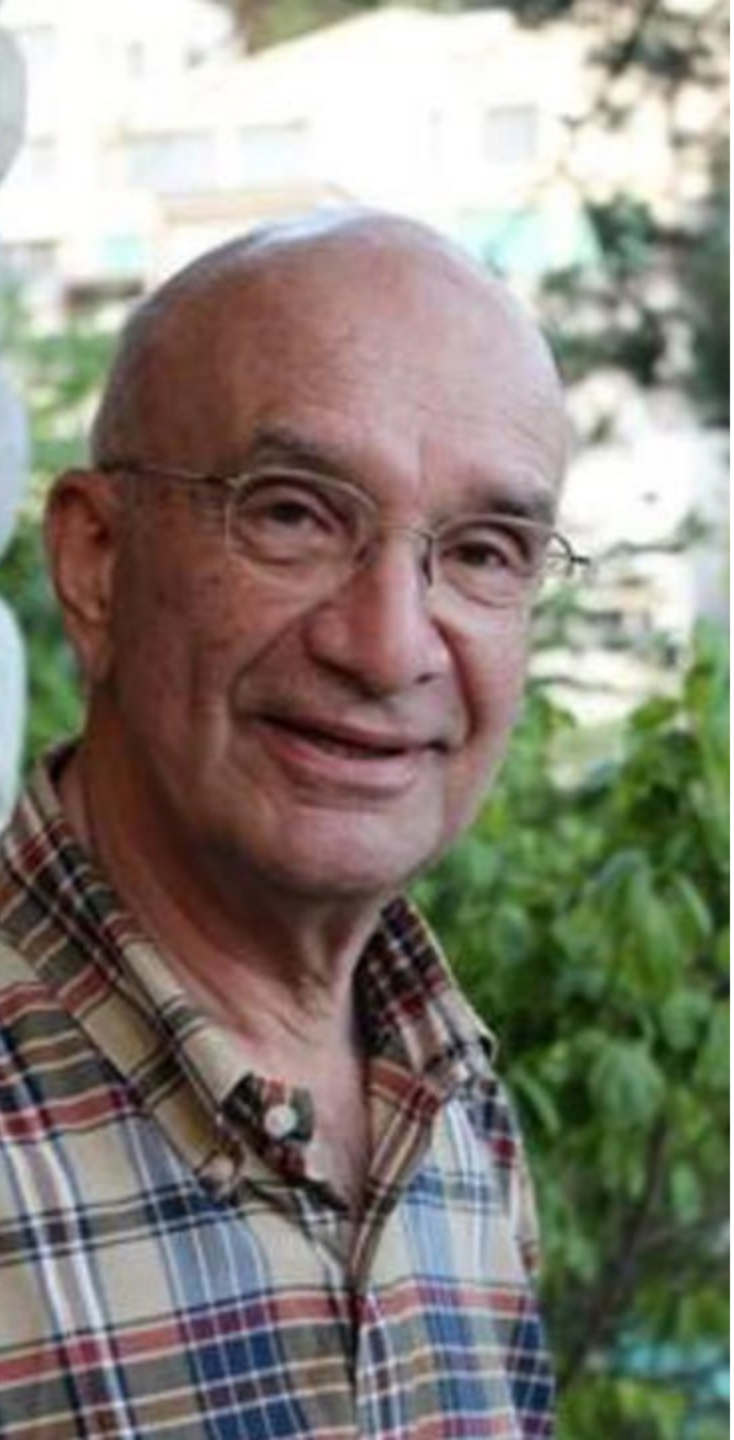


Political Lobbying in Accounting Standard-setting

- **Text readings:**
  - *Comparative International Accounting 14th ed*: Chapter 11

- **Academic paper, on Canvas:**
  - Mozes, H.A. (1998) 'The FASB's conceptual framework and political support: the lesson from employee stock options', *Abacus*, September, pp. 141–61.

- **Self-Study Questions:** See Canvas for instructions



Stephen Zeff

The author of this chapter is Prof. Stephen Zeff.

"Drawing on his extensive fund of knowledge acquired from researching the standard-setting process in eight countries, Zeff imbues his classes with a political perspective that can't be gained from textbooks. "I try very hard to give students a sense of the dynamics by which standards are set," he explains. "It makes the subject come alive. Students realize that it's not just a cold process by which rational accountants come together and say, 'This is the way it's going to be.'"

Learning objectives

After this week's studies, you should be able to:

- define political lobbying
- explain the motivations of companies and governments when they lobby accounting standard-setters
- give examples from several countries of political lobbying in the context of particular accounting standards
- explain why some accounting standard-setters are more subject to lobbying than others
- give examples of lobbying concerning the structure of accounting standard-setting bodies

Introduction

- Is financial reporting like map-making?
  - Does applying accounting standards result in a financial map of the business?
- Are geographical maps "true"?
  - are roads red?
  - are rivers really that wide?
  - in reality, can you see state/country boundaries?
  - Could maps be "political"? Google often gets into trouble with country borders
- Is financial reporting political?
  - Are there "economic consequences" that result from financial reporting?
  - Can financial reports affect share prices, tax bills, executive pay, dividends?

Accounting standard setters

- Accounting standard setters (IASB, FASB, ASB, AASB) have committed themselves to:
  - Act in the interest of investors (not companies or auditors)
  - Use conceptual frameworks
  - Converge their standards
- The term ‘economic consequences’ has been used to describe the impact of accounting on financial reports and decision making:
  - Business, government, unions, investors, creditors all have vested interests in what appears in financial reports
  - They may apply pressure to accounting standard setters to create or change accounting standards to be favourable to their interests

https://www.youtube.com/watch?v=J9TuK7dN1D4

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Lobbying

- Accounting standard-setters use “due process” which includes Discussion Papers and Exposure Drafts
- https://www.ifrs.org/projects/work-plan/
- They *ask* for responses, so what is “lobbying” or “political lobbying”?
  - Lobbying is more open, and “fact” oriented
  - Political lobbying is less open, and can involve covert or overt strategies to influence standard setters. Examples include refusal to apply a standard that is ’unfavourable’; threats to withdraw funding support for standard setters; media campaigns.
  - Compromises the standard-setter’s reputation, independence, powers or even its existence
  - Well established practice in the US for many years, but now used more broadly. The IASB has been subjected to considerable political lobbying more recently
- Concerted campaigns, threats to seek intervention which may include changing the structure or power of the accounting standard-setter
- Political lobbying likely when:
  - new topic
  - new stricter compliance
  - removal of options
  - unwanted effects on “earnings”

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Motivations for lobbyists

- Management's desires about earnings:
    - higher (for stock market and bonuses)
    - less volatile
    - lower (for less tax, publicity and rate regulation)
- Managers are "held to account" by analysts through earnings forecasts
    - HSBC (world's 3rd largest bank) announced pre-tax profit in 2010 that was 169% above previous year, but below analysts' forecasts, and the company's share price dropped 5%
    - Given this, managers want options to manage earnings
    - If standard setters try to limit flexibility, preparers try to influence outcomes
- Management worried about gearing/leverage

Watts and Zimmerman 1978: Three hypotheses in positive accounting theory: bonus plan, debt covenant and political cost.

- Governments worried about investment incentives, bank stability

Arguments

- Arguments against standards most commonly focuses on public policy:
  - Proposal will limit entrepreneurship
  - It will undermine markets
  - Harder for companies to thrive
  - Banks will look “unstable”
- Not so much about “accounting” or the detail
- The financial crisis intensified lobbying:
  - Banks argued they were at risk and that standards needed to change to reduce those risks

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Categories of examples of political lobbying

1. USA to 1990
2. UK to 1990
3. US from 1990
4. 2001+ (FASB and IASB)
5. Lobbying to change standard-setting system

Up to 1990: US

USA to 1990: political lobbying

- The US was one of the first countries to have accounting standard-setters, from 1930s
  - Standards enforced by Securities and Exchange Commission (SEC) since establishment in 1934
  - SEC does not like companies deviating from GAAP and takes a strong stance
  - So, if lobbying were to be successful it had to be targeted at the standard-setters and not the regulator in the US
- 1947-9 (period of high inflation):
  - Some major companies wanted to record depreciation at replacement cost not historical cost. They argued that:
    - depreciation on historical cost caused overstated earnings, which meant they were paying too much tax;
    - labour unions would seek higher wages; and
    - shareholders would demand larger dividends.
- Accounting standard setter refused
  - This was one of the earliest concerted efforts to link accounting measurement and the resulting financial reports to economic consequences.

Example 1: Tax credits (1962-71)

- In 1962 the US government introduced an "investment tax credit" to stimulate the purchase of capital goods.
  - Eg: A company purchasing a $1M piece of machinery could deduct 10% of the purchase price as a credit against its income tax.
  - how should the 10% tax credit be treated in the company's financial reports?
    - companies and government wanted "flow through" with the tax credit taken immediately to earnings
    - After much debate, the Accounting Principles Board (APB) said "deferral" spread over life of asset
      - Argued the credit wasn't revenue, but was a subsidy, so should be subtracted from the purchase price with the net price depreciated over the life of the asset
- The SEC overruled the APB and allowed companies the option of either treatment
    - SEC said forcing deferral lowered income, and would be a disincentive to engage in the purchase of capital goods

Example 1: Tax credits (1962-71)

- The APB assumed the SEC disagreed with it for technical (accounting) reasons
  - It was not known until later that political lobbying had led to the SEC's intervention
  - The issue arose again in 1967, and yet again in 1971
  - Each time, the APB proposed the deferral method but was overruled
  - Eventually (1986), Congress repealed the tax credit
- This issue received extensive comment in the financial news media.
  - This battle over the accounting treatment of tax credits alerted company executives to what could be achieved by political lobbying of the accounting standard-setter.

Example 2: Leases (1971)

- One reason leasing arrangements became popular was that in the absence of a specific accounting standard, the lease arrangement was accounted for as a rental arrangement.
  - Consider large, long-term, non-cancellable leases (such as aircraft)
- APB's first ideas for an accounting involved bringing some of such leases onto the lessee's balance sheet:
  - The leasing industry organised letter-writing campaign to Congress
  - Claims that economic consequences would be disastrous, e.g. rising electricity prices, increasing air fares, stopping investment by small businesses, worsening the US trade balance
  - APB stopped its work on leases

Example 3: Troubled Debt (1973-77)

- FASB founded in 1973 and was soon besieged by political lobbying
  - "Troubled debt" is a good example:
    - In 1974/75 New York City defaulted on debts to banks throughout the US
    - The debt was restructured to extend its maturity and reduce the interest rate, and the banks accepted this.
    - The FASB considered how the banks should reflect this economic loss in their financial statements
- At public hearings, the FASB proposed banks show the debt at market value (FV). This would require the banks to record substantial losses.
  - The banks argued that future restructurings would cease if the FASB required this.
- The FASB did not require the write downs.

Zeff said:

"If the banks that held the New York City obligations had been required to record an immediate write-off of say, 25% of principal as a result of restructuring, that restructuring just might not have happened. Several of the banks whose cooperation was essential might not have been able to afford it, <u>not from an economic point of view, but in terms of the way that readers of financial statements</u> would interpret such changed earnings. Some New York banks were at that time under severe earning pressure and the prospect of a significant additional charge with a corresponding reduction in capital would have been totally unacceptable".

Summary of early US examples of political lobbying

- These early examples highlight the extent and effect of political lobbying in accounting standard-setting.
- To this point, accounting standard-setters had not developed a conceptual framework.

- FASB commenced developing its conceptual framework from mid-1970s
  - Part of the thinking was a conceptual framework would help to reduce political lobbying.
  - If accounting and financial reporting could be made to seem like a technical activity, this would help defend the FASB's accounting standard-setting activities from lobbying.
- Gerboth (1987): it would be a mistake for the FASB to think it could, "avoid, minimise, or control debate on basic issues by prior agreement on abstract principles… the conceptual framework … attempts to improve the form and technique of reasoning, and in disciplines that deal with complex human affairs, the form and technique of reasoning are tangential matters."

Example 4: Oil and gas (1975-81)

- Accounting for oil exploration costs was a major political issue during the 1970s. Until then,
  - large companies tended to use “successful efforts” (expensing costs of exploring dry holes); and
  - smaller companies tended to use “full cost” (capitalising all of the costs).
- In 1975, the SEC asked FASB to establish a single method
  - FASB proposed successful efforts
  - Smaller companies lobbied Congress which drafted a bill to prevent this proceeding
- The FASB issued SFAS 19 which eliminated full costing
  - The SEC held public hearings at which there was extensive political lobbying in opposition to SFAS19
  - Economic consequences claimed by smaller companies: they wouldn’t survive; they would be consumed by big companies, and this violated the nation’s commitment to competition.
- The battle was complicated but ended with all companies being permitted to use either option

Up to 1990: UK

Examples: 1 Inflation Accounting (1970s)

- The Accounting Standards Steering Committee was established in 1970, and companies began to take accounting standards seriously.
  - At the time, companies were required only to show a true and fair view in their financial reports and there was no enforcement of accounting standards.
  - The 1970s was a period of high inflation (up to 25%), and there was a search for a suitable way to reflect the effect of inflation in financial reports
- ASSC proposed ‘current purchasing power’ accounting (1971-1973)
  - This meant indexation of the financial statements for changes in CPI to be provided in a supplementary statement to the financial reports
  - Public accounting firms generally agreed; preparers were opposed.
  - Shortly before the comments period ended, the government established the ‘independent’ Sandilands Committee of inquiry, referring to a range of national interests
  - This “shook the accounting profession” and prevented the standard from being issued.
- Sandilands rejected CPP and supported another method, current cost accounting, (replacement cost)
- This is an example of the “government” lobbying or interfering in the outcomes of standard setters

2 and 3: R&D (1977) and goodwill (1987-90)

- R & D (1977)
  - ASSC proposed immediate expensing of both research and development costs
  - The aerospace industry lobbied for the option to capitalise development costs
  - The final standard did not require development costs to be expensed

- Goodwill (1987-1990):
  - Companies had almost unconstrained choice about the treatment of goodwill. Most companies wrote off goodwill against share capital.
  - In 1990, the ASC tried to remove some of the choices. It proposed goodwill should be amortised over a maximum of 20 years
  - This prompted intense lobbying from CFOs, and remained unresolved when ASC's existence ended. Passed on to the ASC's successor

From 1990: US

1: Marketable securities (1990-93)

- The SEC had tended to oppose carrying any assets at market value but in 1992, following a financial crisis in the savings and loans industry, the SEC proposed that marketable securities be marked to market.
  - FASB began to draft a standard that required valuation of equity securities at market prices, with unrealized gains and losses included in earnings
  - The banking industry and its regulators opposed this and lobbied against it. Even the Secretary of the US Treasury took part in the opposition arguing that severe economic consequences could result, and urging the FASB not to proceed.
- Eventually the FASB compromised, by introducing categories of financial securities.
  - Gains and losses on ‘trading securities’ would be included in earnings, while gains and losses on ‘available for sale’ securities would go to equity.

2: Employee Stock Options (1992-95)

- This example is the most well-known of recent political controversies/lobbying over accounting standards.
  - Stock options became a big part of executive compensation packages (salaries and other benefits). They were especially significant in the growing IT industry.
  - When a company issued stock options to its staff, although it was part of their compensation package, no cost for the stock options was recorded in their financial reports. This meant the size of the compensation packages was not apparent.
- In 1993, FASB proposed requiring companies to value options issued to staff using a FV pricing model, and to report these as an expense
  - Many companies, esp high tech industry, lobbied Congress, which became involved. People at protest rallies in Silicon Valley wore "STOP FASB" T-shirts.
- In 1994, the FASB issued SFAS 123 which allows disclosure-only of the impact the stock options issued would have on company earnings

Journal Article

- Mozes, H.A. (1998) ‘The FASB’s conceptual framework and political support: the lesson from employee stock options’, *Abacus*, September, pp. 141–61.
  - Analysis of accounting for employee stock options in the US
  - Argues the CF fails to provide clear guidance on issues like this. Rather, the CF may support multiple “views”, each of which would result in different accounting requirements.
  - Because of this, the FASB can’t provide leadership: risks losing control and difficulties obtaining regulator’s support for standard-setters accounting proposals. Risks losing control to the SEC

Learning objectives

How does Mozes (1998) relate to the following LOs?

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3: Poolings and goodwill (1996-2001)

- There were two methods of accounting for business combinations: poolings (mergers), and purchases (acquisitions)
  - The pooling method was popular because there was no revaluation of assets and no goodwill
  - The purchase method resulted in goodwill (intangible) which was required to be amortised over 40 years
- In 1999, the FASB issued an ED that proposed abolishing poolings method, and to require goodwill amortisation over 20 years
  - Industry accepted abolition of poolings but lobbied over goodwill amortisation requirement; Senate and House hearings
- The eventual standard, SFAS 142, did not require amortisation, but instead required regular impairment tests.

2001-2009: US and IASB

4: financial instruments, fair value (again): (2008-2009)

- FASB and IASC had both introduced requirements to value financial instruments at FV, but against considerable opposition.
  - In 2008, during the period of the financial crisis, the US Congress authorised SEC to suspend FV accounting, but SEC did not do this
  - Subsequently Congress threatened to pass law on FV
  - The FASB allowed more flexibility in the standard that reduced the size of the losses reported by the banks
  - In the EU, French banks had been complaining that IAS 39 caused volatility in their earnings
  - The French President had involved the European Commission (2003), which amended IAS 39 before endorsing it
  - In 2008, the French government lobbied the European Commission for amendment of IAS 39 to allow transfer of securities from FV category
- The European Commission threatened to dump IFRS; the IASB amended IAS 39 over a weekend

5: Share-based payments again (2001-2004)

- 2001: IASB proposed accounting for share-based payments:
  - Similar to FASB's earlier failed proposal the IASB proposed to value options at fair value and report as an expense.
  - This was the IASB's first substantive standard; advantage from a climate of embarrassment over accounting following financial reporting scandals in the US (Enron, Worldcom etc).
  - Considerable lobbying, including 15 major multinationals arguing this standard would put them at a disadvantage compared with US GAAP
  - IFRS 2 issued in February 2004 requires reporting share-based payments as expense
- 2004: the FASB issued exposure draft similar to IFRS 2; 14,000 comment letters received
  - Congress again became involved opposing it but SFAS 123 (R) issued in December 2004 requires expensing of stock options

Political lobbying to change standard-setting system

- If the standard-setting system can be changed, then this can influence the standards issued from the standard-setting system
- US:
  - 1985: Financial Executives Institute lobbied successfully to increase preparers on FASB from 1 to 2 (out of 7)
  - 1990: more lobbying led to change voting majority needed to 5:2 (from 4:3)
  - 1996: FASB effort to protect independence by requiring four trustees of Financial Accounting Foundation to represent the public interest
  - 2009: US Congress bill to establish 'Federal Accounting Oversight Board' (in context of FV argument)
- IASB
  - 2003: EU Commission persuaded trustees to broaden criteria for IASB membership; and change voting on standards from simple majority of the 14 board members to 9:5 majority
  - 2009: IASB 'Monitoring Board' established. Members include SEC, European Commission and IOSCO representatives

A recent study: Leases

Business Accounting Print article

Lease accounting standards will shift debt back to companies

Agnes King
Accounting Editor

Updated Jan 14, 2016 — 10.23am, first published at 12.00am

Save Share

Companies which have extensive property or equipment leases including airlines and miners are facing new administrative costs after the introduction of long awaited new lease accounting rules.

The rules will transfer billions of dollars worth of debt liabilities onto the balance sheet of groups like Virgin, Qantas, BHP Billiton and Wesfarmers.

The new rules released by the International Accounting Standards Board, which take affect from January 1, 2019 are expected to transfer about $4 trillion worth of off-balance sheet debt liabilities onto companies' books.

Australian Financial Review

REPeC, Brasília, v. 11, n. 4, art. 6, p. 453-470, Oct./Dec. 2017
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ABRACICON

Accounting for lease transactions: analysis of possible lobbying in the issuing of IFRS 16

Abstract

Objective: This study intends to analyze the potential existence of lobbying in the transition process from International Accounting Standard (IAS) 17 to International Financial Reporting Standard (IFRS) 16, issued by the International Accounting Standards Board (IASB) and related to leases.
Method: We collected 641 commented letters that were submitted to public review in the context of the revised Exposure Draft (2013). The study adopts content analysis as a method. Then, the data were submitted to univariate and bivariate content analysis.
Results: The results suggest that lobbying took place, in view of the significant divergences found between financial and non-financial entities with regard to the main aspects of the standard, related to the disclosure and the only lease accounting model.
Contributions: Verifying the existence of significant opinion differences that indicate lobbying in the context of the transition process to the standard promoted by IASB and, in function of the distinct lobbies involved, is the main contribution of this research.
Key words: Comment Letters, Leases, Lobbying, IASB, IFRS 16.

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Summary: Political lobbying in accounting standard-setting

- Financial reports affect many, including those with significant political lobbying power.
  - Political lobbying seeks to influence accounting standard-setters' decisions (many examples listed).
  - Political lobbying also seeks to change the accounting standard-setting system, often in ways that would make it easier to influence the outcome of accounting standard-setters' decisions.
- Part of the thinking behind conceptual frameworks was this would reduce the politics, and help to defend the accounting standard-setters.
  - But accounting standards are socially constructed, they address "complex human affairs", and expectations a conceptual framework would reduce the politics may have been unrealistic.
  - The many examples of political lobbying given, before and since the development of conceptual frameworks illustrate the continued part political lobbying plays in accounting standard-setting.