Solutions manual

to accompany

Contemporary issues in accounting

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Chapter 3: Standard setting

Contemporary issue 3.1

Potential adoption of IFRSs in the United States

Questions

1. **Evaluate the argument that the United States should adopt IFRSs.**
2. **Rules-based standards are supposedly very different from principles-based standards. How are the two types of standards converging? Is this the type of convergence that was envisioned by those advocating IFRSs?**
3. **Why do some US commentators have doubts about the independence of the IASB?**

1. The main argument that the United States should adopt IFRSs relates to the almost worldwide adoption of IFRSs so that adoption would mean that investors in the US would have the same information received in other investment markets. However, evidence from New Zealand suggest that information provided by their adoption of IFRSs has been negative, a situation likely to be repeated in the US where there is distrust of principles-based standards. The clarity and comparability of standards are the main benefits of IFRSs which is claimed to reduce the rules generated from rules-based accounting standards which generate loopholes, a disadvantage of rules-based standards. In addition, principle-based standards focus on the underlying economic circumstances which allow auditors to exercise their judgement about misuse of accounting standards.

2. The implementation guidelines accompanying IFRSs have increased in both volume and complexity which has made principles-based standards look more like rules-based standards. This was not the type of convergence envisaged by those promoting the use of principles-based standards.

3. The IASB is an organisation dependent on external funding, most of which comes from the international accounting firms. Independence in these kinds of situations is questioned – a reminder of the old saying that he who pays the piper calls the tune.

Contemporary issue 3.2

Lobbying: standards not achieving the right solution

Questions

1. **What is lobbying?**
2. **Analyse the various ways of lobbying that are reflected in this case. What kinds of lobbying evade those wishing to expose both lobbying and the effects on IFRSs?**
3. **How does the non-profit status of the IASB and FRC expose these bodies to lobbying?**
4. **The IASB is incorporated in Delaware, United States. Why do you think it is incorporated there rather than in the United Kingdom where it has its headquarters?**

1. Lobbying is the advocacy of a decision making body such as a government or an accounting standards setter with the intention of influencing decisions made by that body favouring the lobbyist.

2. The lobbying is of the open type, namely submissions to an exposure draft, the success of which is dependent on the lobbyist's contribution to the viability of the IASB and the size of the capital market in the lobbyist's home market. The lobbying that goes on beyond closed doors such as using friendship with an IASB Board member or the taking a Board member for a very expensive outing is difficult to detect by those wishing to expose lobbying.

3. The non-profit status of IASB means that it has to raise funds to exist. Research has already exposed that financial contributing lobbyists are more likely to have standards reflecting their views.

4. Delaware, USA, is a pro-business state which is reflected in its corporation law which is said to be the most flexible in the USA. It is a small state which is dependent on the income received from incorporation. It has a special court to rule on corporate law disputes with judges without juries to rule on these disputes. Why the IASB is incorporated in Delaware is not explained in the IASB-related web-sites.

Review questions

3.1 In what sense are accounting standards 'standards' in the general meaning of the word? (LO2)

Accounting standards are set by what can be referred to as 'general consent', which mirrors the dictionary definition of a 'standard'.

3.2 How do principle-based standards differ from rules-based standards? (LO3)

A principle-based standard is based on a concept or concepts which are derived from conceptual framework. Standards based on principles derived from a common conceptual framework should be constituent both within and across standards. A rules-based standard contains specific rules designed to meet as many contingencies as possible. Rules based standards often conflict with other rules-based standards. A rules-based standard is prescriptive; the principles-based one is broader.

3.3 What are the functions of accounting standards? (LO2)

The main function of accounting standards is to guide preparers of financial reports so that information contained therein permits users to make useful decisions based on that information. Another function is to provide a defence for preparers of financial reports based on those standards if a reporting entity fails and misleading accounts are blamed for the failure. Additionally, standards raise the profile of the profession.

3.4 What do you think the standard-setting process should achieve? (LO2)

As this question is targeting the views of those using the text, a single answer cannot be provided for this question. Perhaps views should include the features of consistency, transparency and due process.

3.5 Justify Australia's approach of imposing its set of accounting standards on all reporting entities, irrespective of whether they are profit seeking. (LO2)

Under a principles based system, the definitions of the elements of financial reporting should apply universally. The recognition test arguably should also apply universally. A profit (loss) is derived from the difference between assets and liabilities over a period (itemised in the income statement). A surplus or deficit is also the difference between assets and liabilities; therefore, there is no need technically to have separate standards.

3.6 Define regulation. (LO4)

Mitnick's (1980) definition is that regulation is a policing of some activity by an entity which is not party to, or involved in, the activity being regulated.

3.7 In what ways does accounting standard setting conform to your definition of regulation? (LO4)

This answer will depend on what answer was given to question 3.6. However, the profession's historical intention to intervene in the production of financial information by reporting entities, and the restriction of choice that the intervention generated should be mentioned. The independence of the AASB also should be mentioned.

3.8 If the standard-setting process should achieve better information, what criteria would identify better information? (LO4)

1. common concepts underlying the information
2. similar interpretations of guidance issued by the standards-setting authorities
3. relevance
4. reliability
5. comparability
6. understandability

3.9 Is the setting of accounting standards desirable for society? If so, who should set standards? (LO4)

There are several facets to this question. Responses as to who should set standards will depend on the angle taken in answer to the first part. Students may respond in terms of:

1. social contract theory — in which case standards setters should reflect the composition of society affected by the standards and the organisations to which they apply
2. technical expertise — standards setters should have the expertise necessary to set appropriate standards
3. public interest
4. regulatory approaches, including the difficulty of monitoring and enforcement

3.10 How does good financial reporting add value to organisations? (LO4)

Information is important to the good working of financial markets. Financial reporting makes an important contribution to the information set used by financial market participants. Good financial reporting enhances the reputation of the disclosing entity. Signalling theory suggests a hierarchy of disclosure so that the best reporters are seen as having nothing to hide, thereby adding value.

Good financial reporting also implies adherence to standards, which in turn implies that the information is relevant, reliable, understandable and comparable with other entities — qualities which should add value to the reporting entity.

3.11 Are interested parties behaving ethically when they try to influence the standard-setting process? (LO4)

The answer will depend on the ethical stance of the person advancing the argument, as well as on how and why interested parties try to influence the standard-setting process. For example, if an interested party is trying to capture all the benefits of a particular standard to the detriment of all other interested parties, then they could be argued to be not acting ethically.

3.12 Explain the statement that 'information is the oil that lubricates markets'. How can this statement be used to justify the regulation of accounting information? (LO4)

A perfect market requires perfect information. Without accurate and useful information, the market cannot function. Regulation of accounting information ensures that accounting information, a public good, will not be under-produced. Some argue that without regulation, accounting information would not be produced at all and therefore, markets would not operate efficiently.

3.13 In your opinion, do the benefits from regulating accounting information outweigh the costs? Justify your answer. (LO4)

The benefits relate to:

1. increased efficiency in allocating capital
2. cheaper production of accounting information
3. checks on perquisites
4. public confidence
5. standardisation
6. public good argument.

The costs relate to:

1. attempting to achieve efficiency and equity through regulation
2. determining the amount of optimal information
3. the difficulty of reversing regulation once it is in place
4. the restrictions placed on innovation of ways of presenting and communicating accounting information
5. the imposition of standard reporting systems on entities which are very different
6. regulation generates lobbying which advantages certain interest groups
7. the displacement of contracts as a means of negotiating with management as to the types of information to be disclosed, as well as place and time of information disclosure.

3.14 How do you reconcile the 'adoption' of international accounting standards with the process of harmonisation or convergence? (LO6)

Answers will depend on the position taken by students. However, adoption implies that no changes will be made to the standards by the adopting country. Harmonisation implies that changes will be made to suit the requirements of the adopting country. Such changes reduce the comparability of the resulting financial statements.

3.15 With particular reference to the following opinion expressed by Watts and Zimmerman, discuss whether accounting standards setting is a 'two-edged sword':

> **Regulation affects the nature of the audit. It expands the audit … [R]egulation provides the auditor with the opportunity to perform additional services and lobby on accounting standards on clients' behalf. Regulation also provides the auditor with the opportunity to lobby for increasing accounting complexity because of its audit fee effect.[45]**

(LO4)

A suggested solution to this question is inappropriate, although reference to accounting/auditing incidents such as Enron, WorldCom suggest that Watts and Zimmerman 'were on the money'!

3.16 Drawing on your knowledge of the *Conceptual Framework* and of principles based standards, discuss the following statement:

> **Ultimately, it is the underlying economic substance that must drive the development of the scope of standards, if . . . standards are to remain stable and meaningful.[46]**

(LO3)

Again, a suggest solution is inappropriate, although students should define the key terms of 'economic substance' and 'principles based'.

3.17 What is 'lobbying'? Who would be expected to lobby an accounting standard, and why? (LO5)

Lobbying is the attempt to influence decisions made by officials such as the members of the IASB when setting standards. Lobbying can be viewed as a mechanism by which regulators are informed about policy issues because lobbyists convey their specific knowledge about the issue being regulated. Management can afford to invest more than users in lobbying for their point of view. As a result, standards are more likely to reflect benefits for the reporters of financial information than for users of that information. Certain interest groups such as preparers and auditors seek and gain economic rents by investing resources in the pursuit of favourable regulations.

3.18 Sutton states that accounting standard setting is a political lobbying process, and as such offers several opportunities and means for interested parties to influence its outcomes.[47] What methods do lobbyists employ to influence the outcomes? How has Australia's adoption of international standards affected lobbying activity by interested parties? What are the opportunities that Sutton mentions? (LO5)

What are the opportunities that Sutton mentions?

Various points in the due process procedures; meetings with individual standard setters.

What methods do lobbyists employ to influence the outcomes?

Lobbying methods are classified as either direct or indirect. Direct methods involve communicating with members of the standard setting board. Indirect methods mean communicating via an influential third party.

How has Australia's adoption of international standards affected lobbying activity by interested parties?

The adoption alters opportunities for lobbying. Decisions must be made whether to lobby various members of the IASB directly or only the Australian member; or to lobby members of the Australian liaison board so that the board conveys their viewpoint to the IASB; to make submissions via the Australian body or the international one.

3.19 Hoogendoorn suggests that there is tension between a principles-based interpretation of IFRSs and a rules-based interpretation.[48] If IFRSs are principles-based standards, why should there be such tension? When the US adopts IFRSs, is this tension likely to increase? Why? (LO4 and LO5)

The tension arises from principles-based standards relying on preparers' judgement when preparing financial statements. Judgement is likely to result in a diversity of outcomes so that the resulting financial statements are probably less comparable than under a rules-based system. To avoid the diversity in outcomes, rules for application of the principles-based standard are a solution. If, and when, the US adopts IFRSs, the tension is likely to increase as the US has used rules-based standards for a very long time.

3.20 In relation to the governance of the IASB, who governs the governor? (LO4 and LO5)

From the IASB's website:

"The IFRS Foundation is an independent, not-for-profit private sector organisation working in the public interest...

The governance and oversight of the activities undertaken by the IFRS Foundation and its standard-setting body rests with its Trustees, who are also responsible for safeguarding the independence of the IASB and ensuring the financing of the organisation. The Trustees are publicly accountable to a Monitoring Board of public authorities.”

“Trustees are appointed for a renewable term of three years. Each Trustee is expected to have an understanding of, and be sensitive to, international issues relevant to the success of an international organisation responsible for the development of high quality global accounting standards for use in the world’s capital markets and by other users.
Six of the Trustees must be selected from the Asia/Oceania region, six from Europe, six from North America, one from Africa, one from South America and two from the rest of the world.”

Application questions

3.21 Laughlin stated the following:

Accounting standard setting may not fulfil the litmus test of being ‘regulative and amenable to substantive justification’ due to its active rejection of a wider stakeholder commitment and the preferential treatment of finance capitalists.[49]

(a) What is a ‘litmus test’?
(b) Why should accounting standards be ‘amenable to substantive justification’?
(c) Does the AASB’s User Focus Group provide evidence of ‘the preferential treatment of finance capitalists’ in the standard setting process?

(LO2, LO3 and LO4)

(a) A litmus test in chemistry is a test for chemical acidity using litmus paper. The term has been used to signify a test that uses a single indicator to prompt a decision; in this case Laughlin is suggesting that standard setting would fail the test of substantive justification for standards

(b) Accounting standards can redistribute wealth and in so doing effect many stakeholders. Accounting needs significant social and political studies of accounting standard setting so that the effects of regulation can be assessed. The IASB appears to be largely indifferent to the information needs of any user other than finance capitalists.

(c) The User Focus Group generally comprises eight to ten investment and credit professionals.

3.22 *The Australian* reported that one of Australia’s top accountancy firms said that company annual reports have become too long and it wants IFRSs trimmed. Representatives of the firm said that IFRSs had complicated accounting — for reporting financial instruments alone, there was now more than 300 pages of rules, and guidance that did not exist under ‘the old rules’.
(a) Are IFRSs rules-based or principles-based?
(b) If IFRSs are principles-based, why do you think the standard focusing on financial instruments is accompanied by 300 pages of rules and guidance?
(c) Do you think that the existence of such lengthy guidance notes is what Hoogendoorn was referring to when he commented on the tension between a principles-based interpretation of IFRSs and a rules-based interpretation?
(LO3)

(a) They are principles-based.

(b) Financial instruments are complex commercial instruments (as the Global Financial Crisis revealed). Describing unambiguously the instruments to be accounted for (and those to be excluded) is an issue for standard setters. “Fair value” requires many rules to provide guidance such as which market price should be chosen when there are several market prices for an instrument. The complexity of both financial instruments and fair value has generated the 300 pages of guidance.

(c) Under a principles-based approach, the test is whether an accounting treatment is appropriate in the circumstances. If the IASB wants to avoid diversity in practice, the only solution according to Hoogendoorn is to have more and more detailed rules (or official interpretations).

3.23 Coca-Cola Amatil conducted a campaign against Australia's adoption of IFRSs in 2004. The company lobbied against requirements that meant Coca-Cola Amatil's balance sheet values would have to be written down by as much as $1.9 billion.

(a) What is meant by the term 'lobbying'?

(b) Who would be likely targets of Coca-Cola Amatil's lobbying activities?

(c) Why would adoption of international standards so heavily affect Coca-Cola Amatil?

(d) Did harmonisation affect Coca-Cola Amatil's balance sheet?

(LO5 and LO6)

(a) Lobbying is the attempt to influence decisions made by officials such as the members of the IASB when setting standards.

(b) The FRC, AASB, Federal Government, etc.

(c) IAS 38 would prevent Coca-Cola Amatil from including valuable internally generated intangibles on their balance sheet.

(d) The note from the 2004 financial statements:

> **Intangible assets**
> *Impact on retained earnings of previous revaluation at 1 January 2004 (reduce by approximately $1.9 billion)*

CCA's investments in bottlers' agreements are recognisable under IFRS. However, revaluation of CCA's investments in bottlers' agreements at fair value is not permitted under IFRS. This will result in the reversal of the previous revaluation (as was permitted under the previous version of AASB 1010 "Recoverable Amount of Non-Current Assets" and the current version of AASB 1041 "Revaluation of Non-Current Assets"), thereby impacting retained earnings and net assets on transition to IFRS.

3.24 A New Zealand paper reported that the integrated nature of capital markets, the mobility of capital and the global nature of the financial crises highlighted the need for a single set of high quality globally accepted accounting standards. The report went on to state that banks particularly wanted to eliminate differing accounting treatments between jurisdictions. American banks were reported to have spent US$27.6 million on lobbying for such changes.

(a) Why, in particular, would banks be advocating for a single set of global accounting standards?

(b) Why might American banks be so willing to spend so much on lobbying?

(c) If you were an American bank, who would you be lobbying and why?

(LO3, LO4 and LO5)

(a) Banks borrow and lend internationally. A single set of global accounting standards would simplify their reporting requirements.

(b) You would have expected the banks to conduct a cost-benefit analysis before spending this amount on lobbying. The resulting standards would be expected to justify the expense.

(c) IASB committee members, FASB, Federal US Government, major accounting firms to lobby on their behalf, etc.

3.25 Much publicity has been given to the move by James Hardie Industries, a company that mined, manufactured and distributed asbestos and its related products in Australia, to transfer its domicile to The Netherlands and later Ireland, and to move its asbestos liabilities to a foundation separate from the company. One of the reasons touted for these moves was the impending introduction of an accounting standard that would have required the company to include the present value of all likely future asbestos liabilities in its accounts.

(a) What is the definition of a liability?

(b) What are the recognition tests for the inclusion of liabilities in the financial statements?

(c) How does the long gestation period of diseases resulting from exposure to asbestos complicate the calculation of future liabilities for James Hardie?

(d) Would you have expected the executives of James Hardie to have lobbied against the proposed standard? On what would they have based their argument against its introduction?

(e) Debate the role that the public backlash against James Hardie's moves played in subsequent changes to the foundation holding asbestos liabilities.

(f) Debate whether the executives who made the decisions could have behaved more ethically.

(LO5)

(a) See chapter on conceptual framework: A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(b) (1) probable that any future economic benefit associated with the item will flow from the entity;
(2) the item has a cost or value that can be measured with reliability.

(c) Changes would be expected in the rates of interest used in the calculations – impossible to predict the future.

(d) (1) Yes.
(2) The impact on their reported financial results.

(e) Public backlash is a form of lobbying – in this case, the directors were the target. The backlash also suggests that the public expects corporations to be good public citizens – trying to avoid liabilities is not what one would expect of a good corporate citizen, especially when the James Hardie's decision makers would be receiving bonuses based on profitability.

(f) The debate could focus on the definition of ethics. Ethics can be defined in simple terms as the common concept of "do unto others as you would have done to you". Should this principle apply to executives? A corporation, although recognised as a legal entity, cannot make decisions – individuals within the corporation make the decisions that need to be taken. The debate could also consider whether bonuses based on profitability could skew executive decision making.

Case study questions

Case study 3.1

Greek bonds raise issue of enforcement of IASs

Questions

1. **What is 'GDP'?**
2. **What is meant by 'par value'?**
3. **Do you consider the lack of a common legal enforcement mechanism for IASs a weakness of the concept of common international accounting standards? Give reasons for your answer.**
4. **(a) Why would commentators regard the letter by the Chairman of the IASB to the European Securities and Markets Authority as a form of lobbying?**
   (b) Does the need for the Chairman to lobby an authority highlight the weaknesses of the enforcement system for IASs?
   (c) Give reasons why you think the Chairman kept the letter secret.
5. **The broad principle set out for accounting for financial instruments was that they should be measured at fair value with gains and losses being recognised in the period in which they occur. Why do you think the IASB changed the principle to the rules in the current standard which allows companies to avoid measuring financial instruments at fair value and so violate the principle?**
6. **What theory would explain the actions of the IASB? Give reasons for your answer.**

(LO4 and LO5)

1. GDP (Gross Domestic Product) is one of the primary indicators used to gauge the health of a country's economy. It represents the total dollar value of all goods and services produced over a specific time period, usually a year.

2. The stated or par value of a share.

3. Auditing is the basic enforcement mechanism – the role of auditing in enforcing IASs. Auditors will enforce the interpretation of IASs implied by the country's enforcement mechanisms – the impact on comparability.

4. (a) Because the Chairman was asking the EU authorities to enforce one of the IASB's accounting standards – it has no regulatory authority to make European banks conform with its standards. That power lies with the European Securities and Markets Authority.
   (b) Apparently so.
   (c) International standards are supposedly principles based. To rewrite a standard as a rule implies that the standard setters are open to lobbying and can be coerced.

5. EU's threat to remove sections in the standard relating to fair value accounting. E

6. *Capture theory* holds that regulation is supplied in response to the demands of self-interested groups trying to maximise the incomes or interests of their members.

Bushfire theory highlights the political nature of regulatory influences by attempting to take into account the reactions of users to ‘failures’ in the regulatory processes. Regulations tend to arise from crises such as the GFC.

The *ideology theory* of regulation introduces the role of lobbying in influencing the actions of regulators. Lobbying is viewed as a mechanism through which regulators are informed about policy issues. Interest groups, such as the EU, lobby regulators to convey their specific knowledge about the issues being regulated.

Case study 3.2

International harmonisation of accounting standards

Questions

1. **The conflict between the EU and the IASB suggests that accounting is a social construct. Do you consider accounting to be a social construct or a quasi-science based on precise facts? Justify your answer.**
2. **What is meant by ‘fair value accounting’?**
3. **Why would accounting scandals occur less often with global accounting standards?**
4. **Why would trying to establish a standard based on what an asset is worth result in controversy?**
5. **What lobbying activity, and by whom, would you expect in relation to a measurement standard? You might like to visit the literature about Australia’s attempt to resolve measurement issues.**
6. **Sir David Tweedie has been described as ‘combative’. Is this a characteristic that would be desirable in someone who is trying to negotiate global standards and their acceptance globally?**
7. **Discuss whether individual countries’ interpretations of principles-based accounting standards are likely to undermine the uniformity of global standards.**
8. **Given the dangers identified by Meeks and Swann of a single monopoly standard setter such as the IASB, would it be better to have a duopoly of say, the IASB and FASB? Would regional accounting blocs be desirable from a competitive point of view?**

(LO4, LO5 and LO6)

1. Historically accounting has served as an instrument of various constituents in society. As a social construct, accounting is a tool among other tools to be used to ensure economic stability.

“Science” is defined by the Macquarie Dictionary as the systematic study of man and his environment from which general laws can be drawn and to the knowledge so obtained.

2. Accounting which records assets at amounts for which they could be exchanged between knowledgeable willing parties in an arm’s length transaction, and liabilities at amounts for which they could be settled in an arm’s length transaction between knowledgeable parties.

3. The argument goes along the lines that because capital would be allocated more efficiently with global accounting standards global companies would find it more difficult to pick regulators to suit them so that accounting scandals would occur less often.

4. What an asset is worth is only known after an exchange transaction has taken place, so attempts to predict that worth prior to the transaction are speculative.

5. Large international accounting firms, preparers, multinational corporations, banks, auditors.

6. Not generally so!

7. While differing interpretations would undermine the comparability of global reporting, the interpretations should not undermine the uniformity of the standards.

8. If you believe in competition, then competition between standard setters should result in "better" standards.