# The legitimacy of IFRS

## An assessment of the influences on the due process of standard-setting

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## Abstract

**Purpose** – The purpose of this paper is to assess the influences on the due process of standard-setting with reference to the legitimacy of the financial reporting "soft law" that is International Financial Reporting Standards (IFRS).

**Design/methodology/approach** – This study uses a literature review to analyse the governance structures, due process steps, staffing and funding of IFRS standard-setting activities. The study also uses descriptive statistics to analyse constituent participation during the development of two IFRS standards. The mean, median and standard deviation are used as measures of location and dispersion when analysing constituent participation.

**Findings** – IFRS governance structures are dominated by G20 countries. The International Accounting Standards Board (IASB) depends on international accounting firms, the European Commission and the G8 countries for its financial viability. Well-resourced national standard-setters, major international companies, international accounting firms and educational institutions are able to second their staff to the IASB thereby providing them with direct lobbying opportunities. The IFRS due process procedures provide opportunities for participation but actual participation is dominated by constituents from Europe with African and South American constituents the least active.

**Practical Implications** – IFRS are required or permitted in over 100 countries. The IASB, with no legal or formal mandate, is performing a task normally reserved for national standard-setters. The legitimacy of IFRS is questionable if the standard-setting due process is perceived as invalid.

**Originality/value** – The global financial crisis exposed weaknesses in the IFRS due process when the IASB amended IAS 39 without following the due process. African and South American standard-setters should take note that their lack of participation in IFRS standard-setting, coupled with the influence of powerful stakeholders on IFRS standard-setting, could result in standards not relevant for their regions.

**Keywords** Governance, Legitimacy, Due process, Financial instruments, Standard-setting

**Paper type** Research paper

## Introduction

The global expansion of multinational companies, growth in international trade, cross-border listings and foreign direct investment are some of the factors that precipitated the need to harmonise accounting standards (Martinez-Diaz, 2005; Zimmermann *et al.*, 2008). The need to harmonise accounting standards led to the establishment of the International Accounting Standards Committee (IASC) in 1973 (Camfferman and Zeff, 2006). The IASC published International Accounting Standards (IAS) that were mostly used as reference materials by national standard-setters (Pacter, 2005).

In 2000, the International Organization of Securities Commissions (IOSCO) endorsed a set of 30 IASs as acceptable for cross-border listing (Camfferman and Zeff, 2006;

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Martinez-Diaz, 2005). The European Commission (EC) also announced in the same year that all companies listed within the European Union (EU) were to apply IAS starting in 2005 (Camfferman and Zeff, 2006). The endorsement of IAS by both the EC and IOSCO, and partial acceptance in the USA spurred the global acceptance of International Financial Reporting Standards (IFRS) (IFRSF, 2011a; Zeghal and Mhedhbi, 2006).

With the active involvement of IOSCO and the EC, the IASC was restructured in 2001 to become the International Accounting Standards Board (IASB) with its standards known as IFRS (Danjou and Walton, 2012; Pacter, 2005). The standard-setting structure changed from one with representatives from around the world to one with relatively few (currently 16) experts chosen on the basis of their "technical competence" (Richardson and Eberlein, 2011, p. 226). The objective of the IASB became one of developing a single set of enforceable and globally accepted financial reporting standards (IFRSF, 2010).

The IASB has no powers to enforce the use of IFRS and their acceptance is dependent on their perceived legitimacy. However, at least 145 countries have either adopted IFRS as their accounting standards or converged their national standards with IFRS (FCAG, 2009; IFRSF, 2011b). Of the 145 countries, 101 of them permit or require the use of IFRS by unlisted companies.

The large economies have embraced IFRS to varying degrees. The application of IFRS within the EU is subject to an endorsement process which has features of both technical assessment and political endorsement (Danjou and Walton, 2012). The USA does not allow the use of IFRS by domestic companies, but only by foreign firms listed on US stock exchanges. This is despite the fact that the Norwalk agreement has been effective since 2002 (IFRSF, 2014a). Japan and India allow the voluntary use of IFRS on a limited basis. China has maintained Chinese accounting standards but endeavours to align them with IFRS.

The global adoption of IFRS has coincided with the establishment of regional accounting bodies such as the European Financial Reporting Advisory Group, the Group of Latin American Standard-setters (GLASS), the Asian-Oceanian Standard-setters Group (AOSSG) and the Pan African Federation of Accountants (PAFA) (Alexander and Eberhartinger, 2010; AOSSG, 2011; GLASS, 2012; IASB, 2012). Such bodies have the potential to enhance the legitimacy of IFRS or threaten the effectiveness of the IASB through the development of regional substitutes.

Sir David Tweedie, former chair of the IASB, wrote that "[…] the IASB is in effect setting financial reporting law for more than 100 countries" (IFRSF, 2011b, p. 22). This "soft law" is IFRS, set by a London-based organisation whose parent is a private company incorporated in the USA (FCAG, 2009; Perry and Nölke, 2006). The IASB is not mandated by any national law (Black, 2008) which leads Perry and Nölke (2006) to question the wisdom of placing a traditionally public and national function into the hands of a private entity with multiple principals. The lack of a formal mandate (Black, 2008) and the potential displacement of national accounting standards (Kerwer, 2005) give rise to legitimacy challenges.

This study explores the legitimacy of the financial reporting "soft law" that is IFRS. It is posited that the legitimacy of this "soft law" depends on factors which include the due process through which it is developed and which ought to be valid (Habermas, 1973). The IASB has a technocratic structure (Richardson and Eberlein, 2011) that concentrates standard-setting decision-making in the hands of a small group of board members which creates legitimacy challenges for lack of inclusiveness. The validity of the IFRS standard-setting due process can therefore be assessed according to the conditions of a practical discourse as set by Habermas (1973).

The study assesses the IFRS governance structures, standard-setting processes, staffing and funding. In addition, the participation of constituents during the development of IFRS 9 *Financial Instruments* and IFRS 13 *Fair Value Measurement* are analysed in the context of the global financial crisis. These two standards deal with the controversial accounting aspects of the financial crisis, namely, financial instruments and fair valuation. IFRS 9 is the successor to IAS 39, which was one of the most controversial projects initiated by the IASC and inherited by the IASB (Camfferman and Zeff, 2006). It is important to understand the influences on IFRS standard-setting due processes, as the governance structures are evolving and due process procedures are being enhanced. In addition, politics is ever present in standard-setting due process, as standard-setters are always subject to external pressures (Danjou and Walton, 2012).

The paper is divided into six parts. The first part is a literature review focusing on the conceptualisation of legitimacy, the legitimacy challenges of IFRS and possible legitimation approaches adopted and/or available to the IASB. The second part looks at the causes and impact of the global financial crisis and how they affect the legitimacy of IFRS. The crisis brought intense lobbying that would normally take place privately, into the public domain. The third part focuses on the legitimacy implications of the standard-setting structures, processes and resources. The fourth part discusses the research methodology of analysing the rate of participation in IFRS due process. The fifth part presents the findings regarding the overall and constituent participation in the development of IFRS 9 and IFRS 13. The participation of affected parties in IASB due process is necessary to legitimate IFRS. With limited seats available on governance structures, participation in standard-setting projects is the only chance for all other users of IFRS to influence their content. The final part offers concluding comments arising from the analysis of the legitimacy of IFRS in terms of the standard-setting governance structures, due process procedures, funding, staffing and the rate of participation in standard-setting projects.

## Conceptualising legitimacy

Weber (1978) defines legitimacy as the probability that a command will be obeyed based only on its content. Obedience induced by anything other than a belief in the content of a command is mere compliance. Weber (1978) identifies rational, traditional or charismatic grounds for claiming legitimacy. He defines rational authority as a belief in the legality of enacted rules and the right of those properly elected into positions of power to issue commands. Traditional authority is a belief in the sanctity of age-old traditions which legitimises commands. Charismatic authority is derived from the heroism or exemplary character of an individual.

According to the Weberian conception of legitimacy, any rule established by agreement is deserving of obedience and such obedience is only owed to the rule (Weber, 1978). The consistent interpretation and application of rules requires a bureaucracy to police procedures. The rules can be equated to IFRS and the bureaucracy to the IASB. Weber (1978) argues that the policing of procedures forces powerful interests, which provide technical skills and funding, to battle for the control of the bureaucracy.

Despite its classical status in the study of legitimacy, Weber's conception is repeatedly criticised for confusing legitimacy with a submission to authority

(Grafstein, 1981; Steffek, 2003). Habermas (1973) criticises Weber for failing to make a distinction between legality and legitimacy.

Habermas (1973) argues that legitimacy can be secured through engaging in a practical discourse in which all affected parties, as free and equal, can participate. Such a practical discourse should be underpinned by the non-exclusion of those who can contribute; equal opportunities for all affected to participate; the absence of coercion other than the force of a better argument; and that the only motive of participants is the cooperative search for the truth. Legitimacy is what IFRS requires for the IASB to achieve its objective of "enforceable and globally accepted standards". The IFRS standard-setting due process has to afford all users equal opportunities to influence their content, and the decisions of the IASB board members should only be influenced by a desire to develop appropriate accounting standards.

Some scholars (Cohen, 1988; Dryzek and Niemeyer, 2008; Froomkin, 2003) express doubt regarding the practicality of satisfying the exacting conditions of a practical discourse. Dryzek and Niemeyer (2008) propose representation of all discourses, rather than participation of all individuals, which allows for representatives to shift their standpoint when moved by the force of a better argument. The regionalisation of representatives on IFRS standard-setting structures may be a form of the representation proposed by Dryzek and Niemeyer (2008). Despite the criticism, Habermas's (1973) success in decoupling legitimacy from legal validity makes practical discourse an appropriate theoretical framework to assess the IFRS standard-setting due process. The application of the framework requires an understanding of the legitimacy challenges of IFRS.

The legitimacy challenges of IFRS mostly emanate from the need for states to partially surrender sovereignty and delegate their policy-making responsibilities to unelected IASB board members (Esty, 2006). The reluctance of states to delegate policy-making responsibilities is because of the sensitivities of certain policy fields (Esty, 2006), the uneven representation of countries in the standard-setting governance structures (Helleiner and Porter, 2010) and the outcome responsibility of the state (Zimmermann *et al.*, 2008). Porter (2005) argues that the technical expertise possessed by the IASB is an attraction but not sufficient to legitimate IFRS on its own (Perry and Nölke, 2006).

The legitimacy challenges can be overcome through actions at the institutional and process level. In this regard, the legitimation approaches of Suchman (1995), the global governance toolbox of Esty (2006) and the procedural legitimacy of Richardson and Eberlein (2011) are ideal for enhancing the standard-setting due process.

Suchman (1995) identified three primary forms of legitimacy: pragmatic, moral and cognitive. Pragmatic legitimacy is based on self-interest calculations and can be acquired through the co-option of powerful stakeholders into decision-making structures. The co-option of IOSCO and the EC into IFRS governance structures and the convergence agreement with the Financial Accounting Standards Board (FASB), the US standard-setter, can be interpreted as a means by the IASB to acquire pragmatic legitimacy. Moral legitimacy is based on an evaluation of procedures and structures. Cognitive legitimacy, which Suchman (1995) considers to be the most subtle and powerful type, is achieved when an institution and its activities have gained a higher level of acceptance. The restructuring of the IASC into the IASB was conducted in a manner that led it to mirror the FASB, a major national standard-setter with an undisputed national mandate (Pacter, 2005).

Esty (2006) proposed a global governance toolbox anchored on four dimensions: controls on corruption; systematic and sound rulemaking; transparency and public participation; and power sharing. Esty (2006) argues that constituents are already familiar with domestic administrative law provisions and would find them acceptable if they are adopted in the development of transnational standards such as IFRS.

Richardson and Eberlein (2011) argue that the legitimacy of the due process is a three-stage process: input, throughput and output legitimacy. Input legitimacy is concerned with the participation of affected parties, throughput legitimacy refers to the fairness of transforming inputs into outputs and output legitimacy is about the successful discharge of appropriate outcomes. The IASB should encourage the participation of affected parties; it must carefully consider all inputs and develop appropriate IFRS. The Trustees of the IFRS Foundation, the overseer of the IASB, emphasises due process procedures which are outlined in their constitution (IFRSF, 2010) including the establishment of a Due Process Oversight Committee (DPOC) as a means of ensuring adherence to acceptable norms of rule-making.

It is possible to combine Richardson and Eberlein's (2011) procedural legitimacy with Suchman's (1995) moral philosophy and Esty's (2006) toolbox into a cocktail of governance measures capable of legitimising IFRS. It seems that such a combination of measures has the potential to meet the exacting conditions set by Habermas (1973).

In addition to the inherent legitimacy challenges, Arnold (2009) argues that the global financial crisis made it imperative to analyse the relationship between accounting and the macro political and economic environment. She argues that accounting standards have redistributive effects: they shape and are shaped by power relations, and are influenced by ruling elites and dominant ideologies. According to this argument, the needs of powerful stakeholders may be met at the expense of all other users, violating the requirements of a valid practical discourse.

## The legitimacy implications of the global financial crisis

The global financial crisis, which began in 2007, was triggered by a liquidity crisis at two hedge funds owned by Bear Stearns because of their inability to meet the margin requirements of lenders resulting in forced assets sales in a declining market (Krohn and Gruver, 2009). Some of the causes of the crisis include loose credit practices (Krohn and Gruver, 2009), poor regulation of the shadow financial sector and weak diligence by institutional investors (IMF, 2008), excessive risk taking and conflicted credit rating agencies (IOSCO, 2008). Subprime loans originated by brokers were packaged into structured credit products and securitised into AAA-rated investment products to meet the needs of institutional investors (IMF, 2008). This originate-to-distribute lending model incentivised loan originators to sign up more clients without conducting proper credit checks (IOSCO, 2008).

The IMF (2008) estimated potential losses of over US$1.4 trillion to financial institutions. Repercussions to the rest of society included the repossession of mortgaged houses, rising unemployment, unavailability of loans for businesses, economic contraction (recession) and diminished investor risk appetite that slowed investment. The impact of the crisis was felt in both rich and poor countries despite originating in developed countries. Lehman Brothers, a well-established financial institution, filed for bankruptcy and other financial institutions collapsed or were forcibly acquired (Krohn and Gruver, 2009).

Financial institutions had to absorb valuation losses and the market value of listed entities declined significantly (ECB, 2008). Governments had to guarantee the debts of large financial institutions and central banks were forced to cut lending rates and loosen money supply (ECB, 2008). The scale of the valuation losses led to a debate on the role of accounting standards in causing or exacerbating the crisis (IASCF, 2009).

Critics blamed fair value accounting for requiring inappropriate write-downs at a time when markets were "inactive, illiquid or irrational" (SEC, 2009, p. 1). In particular, IAS 39 *Financial Instruments: Recognition and Measurement* did not permit the reclassification of certain financial instruments in the same way as the provisions of US Generally Accepted Accounting Practice (GAAP) to make it possible for an entity to minimise its fair value losses (IASB, 2008). The EC argued that financial institutions applying IFRS were being forced to absorb more fair value losses than their US counterparts.

The EC put pressure on the IASB to amend IAS 39 to permit the exclusion of certain financial instruments from being measured at fair value (IASCF, 2009). The amendment was effected without following due process (FCAG, 2009), as no exposure draft was issued and no comments were invited from constituents, because the IASB wanted to address "this issue urgently in the light of market conditions" (IASB, 2008). The IASB only requested permission from the Trustees of the IFRS Foundation to waive due process (IASCF, 2009). The waiving of due process requirements by the Trustees was not provided for in the IFRS governance procedures at the time, which damaged the credibility of the IASB and the integrity of the IFRS standard-setting due process (FCAG, 2009).

The action of the EC in pressuring the IASB may be in keeping with the state's outcome responsibility as argued by Zimmermann *et al.* (2008). The same kind of political pressure came from selected global political leaders, who, under the aegis of the Group of Twenty (G-20), recommended that the IASB and FASB accelerate their convergence of accounting standards and simplify accounting standards for financial instruments (FCAG, 2009). The political pressure applied on the IASB is consistent with the conclusion of Sacho and Oberholster (2008) that the IASB will remain vulnerable to external influence and powerful interests.

Under instruction from the US Congress, the SEC (2009) undertook a study which absolved accounting standards of any responsibility for the collapse of US banks but recommended the development of application guidance. The absence of application guidance led to doubts about the validity of the carrying values of financial instruments disclosed in financial statements (IMF, 2008). The IMF (2008) faulted accounting disclosure requirements for being inadequate which left users of financial statements in the dark about the extent of the subprime exposure of the reporting entity.

The IASB, together with the FASB, commissioned an advisory group, the FCAG (2009) to advise on the standard-setting implications of the financial crisis and potential changes to the global regulatory environment. Importantly, the FCAG also absolved accounting standards of blame for causing the crisis but noted weaknesses that included difficulties in applying fair value accounting. It recommended improvements to the independence and accountability of the IASB to enhance the legitimacy of IFRS. It defined independence as freedom from the undue influence of special interests and policymakers. In this regard, the FCAG expressed concern that the EC had pressured the IASB to amend IAS 39 after the FASB had also amended *SFAS 157: Fair Value Measurement*, also under pressure from the US Congress. The FCAG (2009, p. 15) concluded that such "rapid, piecemeal, uncoordinated and prescribed changes to standards" undermine the legitimacy of IFRS.

## IFRS standard-setting due process

Structures, procedures and resources are a codification of power relations and due process is a trade-off relationship among them (Botzem and Quack, 2009). Due process is therefore a standard-setting dispute resolution mechanism and a demonstration of transparency without constraining the decision-making authority of the IASB. The financial crisis highlighted the importance of governance structures, due process procedures, technical expertise and funding in the IFRS standard-setting due process (European Parliament, 2008). Technical expertise and funding impact the operational and financial viability of the IASB (European Parliament, 2008; Mattli and Buthe, 2005) in the same way Weber (1978) identified the importance of technical expertise and funding to a bureaucracy. The sections below discuss the status and influences on IFRS governance structures, due process procedures, staffing and funding.

### *Governance structures*

The global financial crisis led to changes in the oversight structures and due process of the IASB with the introduction of the Monitoring Board, the expansion of the membership of existing structures and the introduction of additional advisory committees (IFRSF, 2011a, 2011b, 2012a, 2014b). The IFRS standard-setting structure is shown in Figure 1 below.

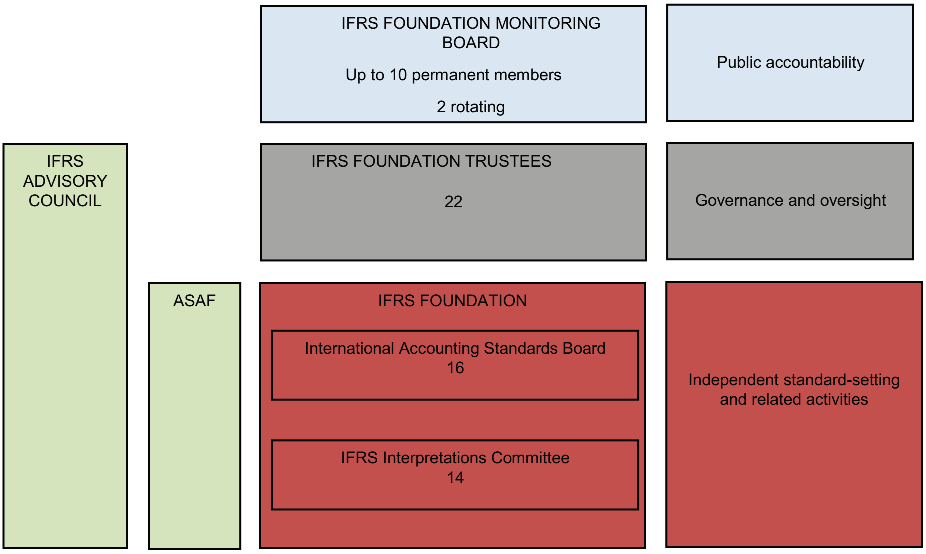



**Figure 1.**
Oversight of IFRS standard-setting

**Source:** IFRSF (2012a, 2014a)

The Monitoring Board was established in 2009 with the responsibility of appointing and supervising the Trustees (IFRSF, 2010). Its initial membership of six was limited to capital market authorities of the EU, Japan, the USA and three members from IOSCO. The membership was subsequently expanded with a further four permanent members and two rotating seats. Representatives from South Korea and Brazil were appointed permanent members in 2014, but the other two permanent seats were left vacant (IFRSF, 2014b). The Monitoring Board is intended to link IFRS governance to capital market authorities (IFRSF, 2011a) and to align the governance of the IASB with that of the FASB (FCAG, 2009). The use of IFRS by unlisted entities (IASPlus, n.d.) and the differences between the legal framework establishing the IASB (IFRSF, 2010) and the FASB (SEC, 2009) create doubt about the effectiveness of the Monitoring Board in its current design. Danjou and Walton (2012) argue that European politicians are concerned that IFRS oversight is organised around market regulators as opposed to countries where the use of IFRS is required. Both the USA and Japan have large market capitalisation but only permit limited use of IFRS.

The IFRS Foundation is managed by 22 Trustees distributed as follows: six each from the Asia/Oceania, Europe and North America regions; one each from Africa and South America; and two from any other region (IFRSF, 2010). The distribution of Trustees is intended to reflect the world's capital markets. The Trustees appoint and supervise members of the IASB and the IFRS Interpretations Committee (formerly IFRIC), establish due process procedures and finance the standard-setting activities (IFRSF, 2010). The governance structure of the IASB and its funding have to support the independent development of IFRS (Danjou and Walton, 2012).

The IASB is the standard-setting body complemented by the Interpretations Committee, which interprets or clarifies IFRS (IFRSF, 2010). The IASB has 16 members with four each from the Asia/Oceania, Europe and North America regions; one each from Africa and South America; and two from any other region. The two extra seats are currently allocated to Asia/Oceania and Europe (IFRSF, 2012a). The consideration of geographical representation for a structure that is largely technical is an acceptance of the political nature of standard-setting.

The Interpretations Committee has 14 members whose selection is not based on geographical balance (IFRSF, 2010). All the big four international accounting firms, major financial backers of the IASB, have their partners serving on the committee. The EC and IOSCO have observer status which provides a direct lobbying opportunity, as an observer can speak at meetings but cannot vote (IFRSF, 2012a). According to Danjou and Walton (2012), geographic diversity is applied to the selection of Trustees, Board members and IASB technical staff to avoid domination by a single group of constituents. This makes the composition of the Interpretations Committee an anomaly, a departure from the norm for a committee heavily involved in ensuring consistent application of IFRS.

Table I below shows that the combined IASB and the Interpretations Committee membership currently favour Europe when the prescribed geographical allocation applicable to IASB membership is applied to the Interpretations Committee as well. The Interpretations Committee is an extension of the IASB because its decisions clarify issues in IFRS hence affects the interpretation and application of standards. It is therefore logical to apply the geographical representation applicable to the IASB (as

**Table I.** The allocation of IASB and Interpretations Committee seats

| IASB region | IASB Constitution | IASB Current | Interpretations Committee *Proportional | Interpretations Committee Current | Ideal | Combined Current | Combined Difference |
|---|---|---|---|---|---|---|---|
| Africa | 1 | 1 | 1 | 0 | 2 | 1 | −1 |
| Asia/Oceania | 4 | 5 | 4 | 4 | 8 | 9 | 1 |
| Europe | 4 | 5 | 4 | 6 | 8 | 11 | 3 |
| North America | 4 | 4 | 4 | 4 | 8 | 8 | 0 |
| South America | 1 | 1 | 1 | 0 | 2 | 1 | −1 |
| Other | 2 | 0 | 0 | 0 | 2 | 0 | −2 |
| Total | 16 | 16 | 14 | 14 | 30 | 30 | 0 |

**Note:** *Applying the distribution of IASB seats as prescribed in the IFRSF constitution
**Source:** IFRSF (2010, 2012a, 2014a)

shown in the proportional column); otherwise, the context and concerns of the regions left out, may not be considered.

Two formal advisory committees are involved. The IFRS Advisory Council, with 53 members, advises the IASB and the Trustees of the IFRS Foundation on agenda decisions and priorities. The members are appointed by the Trustees from interest groups affected by and interested in the work of the IASB, but not according to geographical representation (IFRSF, 2013). The other advisory committee is the Accounting Standards Advisory Forum (ASAF) established in 2013. The objective of the ASAF is to provide an advisory forum where the members contribute toward the IASB's goal of developing a single set of globally accepted and high-quality financial reporting standards (IFRSF, 2014c). The 12 members are representatives of major national or regional bodies interested in the setting of accounting standards in accordance with the IASB's global goal. The members are appointed by the Trustees to represent a broad geographical involvement. The membership comprises individuals from Africa (one), Asia-Oceania (four), Europe (four) and the Americas (three) (IFRSF, 2014a).

Since 2013, the IFRS governance structures (Monitoring Board, IFRS Foundation, IASB and the Interpretations Committee) have filled 60 of the available seats, 53 (88 per cent) of which are occupied by representatives from G20 countries (IFRSF, 2014a). All the structures except the Interpretations Committee are chaired by current or former IOSCO officials (IFRSF, 2014a). The structures operate in terms of agreed due process.

*Due process procedures*

The due process procedures of the IASB are a six-stage process: agenda setting, project planning, the publication of a discussion paper, the publication of an exposure draft, IFRS publication and post-implementation review (IFRSF, 2012b). Opportunities exist for constituents to participate and influence standard-setting when exposure drafts are published for comments. Consultation documents (CDs) are available on the website and IASB meetings are open to the public through physical or electronic means. The normal comment period for an exposure draft is 120 days but a shorter period of not less than 30 days can be approved depending on the circumstances (IFRSF, 2012b).

The publication of an IFRS or exposure draft requires the support of at least nine IASB Board members to limit the influence of special interests (Richardson and

Eberlein, 2011). National standard-setters with formal liaison relationships with the IASB have more participation opportunities because they contribute research outputs which sometimes serve as the backbone of discussion papers or exposure drafts before they become public documents (IFRSF, 2010; IFRSF, 2012b).

Although the due process procedures seem to offer participation opportunities for affected parties, Burlaud and Colasse (2011) argue that they are a ritual procedure intended to create an impression of a transparent process in which all voices are heard yet they have fundamental flaws. The public does not vote on the standards, participation is costly in terms of technical expertise and effort and the IASB can still make its own choices even after the comments have been received. The eventual IFRS is still binding even on those who dissented or did not participate (Burlaud and Colasse, 2011).

This view is supported by the conclusion of Ram and Newberry (2013), who analysed the development of *IFRS for SMEs*. They concluded that the IASB often tended to lack substantive engagement in considering views raised during public consultation and only made changes when requested by powerful regulators. Ram and Newberry (2013) argued that the IASB was already committed to maintaining its recognition and measurement requirements before the public consultation process had begun. The final version of the standard became a pragmatic exercise in vote buying, as the IASB made changes to gain the support of powerful stakeholders. Despite the political considerations that occasioned the changes, the basis for conclusions provides seemingly rational explanations for the IASB decisions (Ram and Newberry, 2013).

The due process procedures offer participation opportunities, though not equal, for affected parties. The main concern is the seriousness with which inputs are considered by IASB board members given competing interests. The actions of the IASB of kowtowing to powerful interests can cause other affected parties to stay away from standard-setting activities if they believe that they have no real prospect of influencing the content of standards.

*Staffing*

The IASB had an average of 136 employees in 2013 (IFRSF, 2014a) including technical staff responsible for the research and drafting of discussion papers, exposure drafts and standards (IASCF, 2009). According to Ram and Newberry (2013), the technical staff can affect the outcome of the standard-setting process, as they define and manage a project and are responsible for filtering information reported to board members. They cite an example of the IASB appointing a director for the SME project who reported directly to the IASB chairman as opposed to the usual structure of a project manager reporting to senior technical staff.

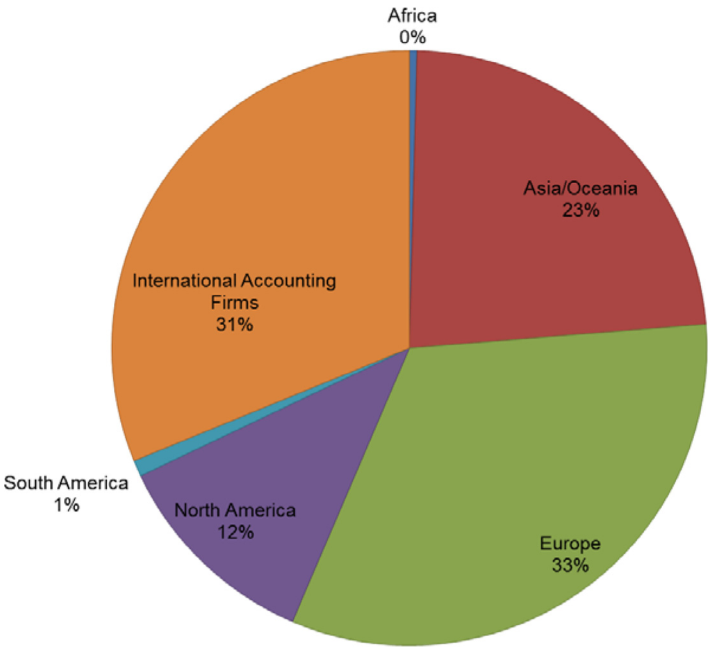
National standard-setters, international accounting firms and companies second project managers, technical associates, practice fellows and industry fellows to the IASB (IASCF, 2009; IFRSF, 2011b, 2012a). Seconded staff are not paid by the IASB but by the organisations seconding them subject to reimbursement of a standard rate (IFRSF, 2015). Data on the breakdown of staff per category or their nationality are not public (or publicly available). Technical associates are staff in the early stages of their careers, practice fellows come from large accounting firms and research institutions while industry fellows are seconded by major international companies subject to a selection process (IASCF, 2009).

The practice of seconding staff provides the IASB with technical expertise required for its operational viability but it also provides a direct lobbying opportunity for well-resourced national standard-setters, companies, firms or educational institutions that are able to second staff. The seconding of staff provides an opportunity to influence standard-setting directly, as technical staff prepare discussion documents for IASB board members.

*Funding*

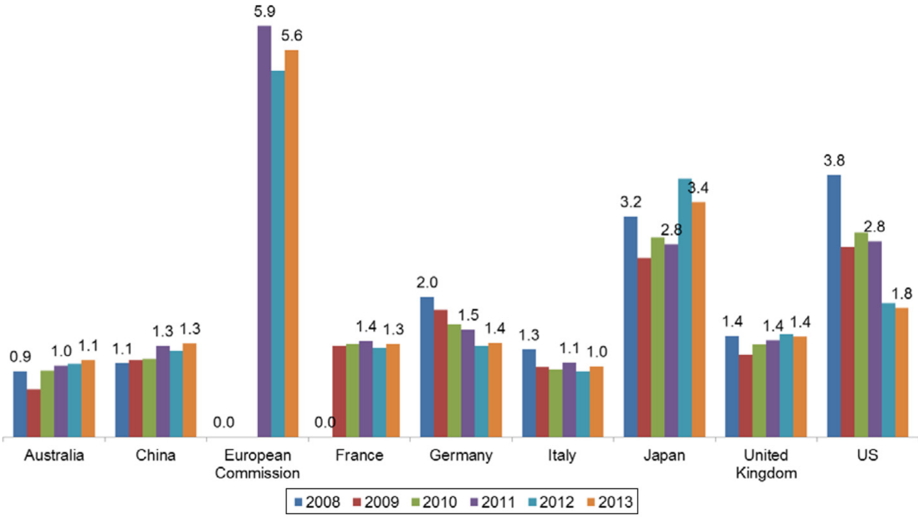
On average, 78 per cent of the IFRS funding comes from voluntary contributions, 21 per cent from the sale of publications and the remainder from other income (IFRSF, 2011b, 2012a, 2014a). Figure 2 shows the source of the voluntary contributions from 2008 to 2013. During 2013, voluntary contributions of US$35m came from 32 countries including 20 of the countries represented on IFRS governance structures (IFRSF, 2012a, 2014a). The big four international accounting firms (Deloitte, Ernst & Young, KPMG and PwC) each contributed an equal amount of $2.5m in 2013 (IFRSF, 2014a). The accounting firms can affect the financial viability of the IASB, as they contribute close to a third (31 per cent) of voluntary contributions.

There has been a significant shift in the composition of the voluntary contributions since the onset of the global financial crisis. There are eight countries, mostly G8 countries, which contribute more than US$1m each year to the IFRS Foundation as shown in Figure 3 below. Three of the four initial members of the Monitoring Board (the




**Note:** Average share of IFRS funding contributions – 2008 to 2013
**Source:** IFRSF (2011b, 2012a, 2014a) and IASCF (2009, 2010)

**Figure 2.**
Share of IFRS voluntary funding contributions




**Note:** Top IFRS funders ($m) excluding international accounting firms
**Source:** IFRSF (2011b, 2012a, 2014a) and IASCF (2009, 2010)

**Figure 3.**
Top IFRS funders

EC, Japan and the USA) are the largest financial contributors excluding international accounting firms. The EC only began contributing financially in 2011 and the USA has halved its contribution to just under US$2m. Japan is funding the IFRS Asia/Oceania office in Tokyo, the only such office outside of the London offices of the IFRS Foundation. Sacho and Oberholster (2008) argued that the rise in the prominence of the IASB and IFRS will force politically influential organisations to start funding the IASB.

All countries represented on the governance structures contribute to the funding. The Trustees have expressed their concern (IFRSF, 2011a) about the possible lack of objectivity when dealing with the requests presented by funders. The inclusion of financial contributors on governance structures may create a perception of a pay-to-play arrangement which can undermine the legitimacy of IFRS.

Overall, the governance structures seem to favour membership from the G20 countries and/or those influential within IOSCO. These structures have an obvious strong influence on the due processes of IFRS development. The geographical representation is not balanced, and more importance is given to funding and governance by technical experts (for similar influences and liaisons governing the structures of the International Federation of Accountants, see Loft *et al.*, 2006). A possible threat of these structures to the legitimacy of the IFRS standard-setting due process is that the concentration of governance in the elite undermines representativeness and a transparent democratic process (Loft *et al.*, 2006).

The majority of countries not represented on the governance structures but following IFRS for reporting purposes still have an opportunity to influence the content of standards through the submission of inputs during the development of standards. The next section outlines the research methodology of analysing constituent participation in the IFRS standard-setting due process.

## Research methodology for the analysis of constituent participation

Constituent participation in standard-setting has been studied by several authors (Georgiou, 2004, 2010; Hansen, 2011; Larson, 2007; Larson and Herz, 2011; Watts and Zimmerman, 1978). These studies were conducted prior to the global financial crisis, did not analyse due process structures and procedures and the standards analysed were not IFRS 9 and IFRS 13 analysed in this paper. This study, like previous ones, uses descriptive statistics to analyse constituent participation in the IFRS standard-setting due process. The study is intended to establish the rate of participation and not the content of submissions. The mean, median and standard deviation are used as measures of location and dispersion (Hirschberg *et al.*, 2005). Tables are used to present certain research findings.

The data used to analyse participation were the comment letters submitted by constituents during the development of IFRS 9 and IFRS 13. Although comment letters are not the only form of participation in the standard-setting due process, they are the only form of participation with publicly available data. Several scholars (Georgiou, 2004, 2010; Hansen, 2011; Larson, 2007, Larson and Herz, 2011) have relied on comment letters as a proxy for participation in standard-setting. Comment letters have also been found to be a widely used and an effective form of participation in standard-setting due process (Georgiou, 2004).

IFRS 9 and IFRS 13 were chosen as both standards address the accounting requirements for financial instruments, an issue that attracted much debate during the global financial crisis (FCAG, 2009). IFRS 9 will replace IAS 39, which Camfferman and Zeff (2006) describe as one of the most controversial and most revised standards and whose amendments in 2008 did not follow the laid down due process procedures.

The development of IFRS 9 was divided into three phases: classification and measurement, impairment and hedge accounting. IFRS 13, published in May 2011, deals with fair value measurement guidance that was the focus of attention during the global financial crisis. The development of the two standards generated 13 CDs published between November 2006 and August 2011. The comment letters are publicly available on the IASB website.

## Findings

The 13 CDs published were made up of three discussion papers (CD1, CD6 and CD11), a request for information (CD3) and nine exposure drafts. Ten documents (CD1 to CD10) were published during the development of IFRS 9 and the other three documents (CD11 to CD13) were published during the development of IFRS 13. Three exposure draft CDs (CD2, CD7 and CD10) were available for comment for a minimum of 60 days which is half of the normal comment period, above the minimum allowable period of 30 days but below the 90 days that Bradbury and Van Zijl (2006) found to be average. Three CDs (CD1, CD4 and CD11) were exposed for longer periods than the constitutionally required 120 days. The development of IFRS 9 and IFRS 13 generated a combined 2,098 comment letters as shown in Table II below.

### *Overall participation*

Of the over 145 countries that permit or require the use of IFRS, only 50 (34 per cent) countries submitted comment letters. The 50 countries that submitted comment letters

| CD code | Document title | Publication date | Comment period in days | Comment letters Total no. | Comment letters % of total |
|---|---|---|---|---|---|
| CD1 | DP 2008 Reducing complexity in reporting financial instruments | 03/2008 | 180 | 165 | 8 |
| CD2 | ED/2009/7 Financial instruments: classification and measurement | 07/2009 | 60 | 246 | 12 |
| CD3 | RFI 2009 Request for information (expected loss model) impairment of financial assets: expected cash flow approach | 06/2009 | 90 | 89 | 4 |
| CD4 | ED/2009/12 Financial instruments: amortised cost and impairment | 11/2009 | 240 | 192 | 9 |
| CD5 | Supplement to ED/2009/12 Financial instruments: amortised cost and impairment | 01/2011 | 90 | 215 | 10 |
| CD6 | DP/2009/2 Credit risk in liability measurement | 06/2009 | 90 | 123 | 6 |
| CD7 | ED/2010/4 Fair value option for financial liabilities | 05/2010 | 60 | 138 | 7 |
| CD8 | ED/2010/13 Hedge accounting | 12/2010 | 90 | 247 | 12 |
| CD9 | ED/2011/1 Offsetting financial assets and financial liabilities | 01/2011 | 90 | 165 | 8 |
| CD10 | ED/2011/3 Mandatory effective date of IFRS 9 | 08/2011 | 60 | 131 | 6 |
| CD11 | Discussion paper: fair value measurements | 11/2006 | 180 | 136 | 6 |
| CD12 | ED/2009/5 Fair value measurement | 05/2009 | 120 | 160 | 8 |
| CD13 | ED/2010/7 Measurement uncertainty analysis: disclosure for fair value measurement | 06/2010 | 90 | 91 | 4 |
| | | | | 2098[a] | 100 |

**Note:** [a] The number of letters received in respect of IFRS 9 (CDs 1-10) and IFRS 13 (CDs 11-13) were 1,711 and 387, respectively

**Table II.** The number of comment letters submitted to the IASB during the development of IFRS 9 and IFRS 13

account for 79, 93 and 97 per cent of the population, gross domestic product (GDP) and market capitalisation of the countries that require or permit the use of IFRS.

All countries with seats on IFRS governance structures had participants that submitted comment letters. Comment letters were received from constituents in 18 (90 per cent) of the G20 countries. With the exception of four countries (Bulgaria, Cyprus, Kazakhstan and Nigeria), all countries that made financial contributions in 2011 submitted comment letters.

Table III shows the proportion of each IASB region's key participation indicators for governance structures and IFRS standard-setting projects. It shows the proportion of governance seats, contribution to IASB funding, use of IFRS, GDP, market capitalisation and population.

The Africa region contributed 2 per cent of all comment letters which was in line with its proportion of GDP and market capitalisation. The Asia/Oceania region submitted 22 per cent of the comment letters which was below its proportion of GDP and stock market

**Table III.**
A comparison of some key participation indicators by region

| IASB region | % of IFRS governance seats | % of IASB funding* | % of countries using IFRS | % of GDP | % of market capitalisation | % of population | Comment letters (%) |
|---|---|---|---|---|---|---|---|
| Africa | 4 | 0 | 17 | 2 | 2 | 10 | 2 |
| Asia/Oceania | 32 | 23 | 28 | 31 | 31 | 63 | 22 |
| Europe | 36 | 33 | 29 | 32 | 25 | 11 | 52 |
| North America | 25 | 12 | 18 | 30 | 38 | 10 | 22 |
| South America | 4 | 1 | 8 | 5 | 3 | 6 | 1 |
| Total | 100 | 69 | 100 | 100 | 100 | 100 | 100 |

**Note:** *The balance of 31 % was contributed by international accounting firms capitalisation. The region then held 32 per cent of IFRS governance seats which was in line with its share of most indicators, except the population.

The European region contributed 52 per cent of comment letters, yet its proportion of GDP and market capitalisation in 2011 was 32 per cent and 25 per cent, respectively. The European region occupied 36 per cent of all IFRS governance seats, the highest of any region.

North America accounted for 22 per cent of comment letters which was lower than its share of GDP (30 per cent) and market capitalisation (38 per cent). The region occupied a quarter of the IFRS governance seats. South America contributed 1 per cent of the comment letters which was below its proportion of all other indicators.

There were differences in the type of participants across the IASB regions. Financial institutions were the most active interest group in Asia/Oceania (28 per cent), Europe (37 per cent) and North America (46 per cent). In contrast, national standard-setters were the most active interest group in Africa (50 per cent) and South America (32 per cent) but only second in Asia/Oceania (21 per cent), fourth in Europe (12 per cent) and joint fourth in North America (5 per cent). The differences in the participation of the various interest groups, especially regulators and national standard-setters, have legitimacy implications for IFRS. The absence of regulators from the process could result in them not authorising the use of IFRS in their jurisdictions if they have no confidence in due process.

The analysis of the comment letters, submitted during the development of the two standards, is analysed separately under the next two subheadings. The two standards dealt with related but separate issues hence their appeal to different constituents of the IASB would not be expected to be the same based on the argument by Watts and Zimmerman (1978) that firms participate if proposed standards have potential impact on cash flow.

*Constituent participation in the development of IFRS 9*

The IASB received 1,711 comment letters from 570 participants representing an average of three letters per participant. Three exposure drafts (CD2, CD5 and CD8) had responses exceeding 200 comment letters with CD8 recording the maximum response rate of 247 comment letters suggesting that constituents may have been more interested in the classification and measurement, impairment and hedging of financial instruments. The minimum response was 89 comment letters received in respect of CD3 which was not an exposure draft but a request for information. The mean and median response rates were 171 and 165 comment letters, respectively. In all, 60 per cent of the CDs had response rates below the mean of 171.

Only 32 participants (6 per cent), mostly national standard-setters (32 per cent) and financial institutions (29 per cent), commented on all ten CDs while another 284 participants (50 per cent) only submitted a single comment letter.

Table IV shows the number of comment letters submitted by each interest group per CD. The mean, median and standard deviation of comment letters submitted by each interest group are also shown.

The next section analyses the participation of constituents in the development of IFRS 13.

**Table IV.**
The number of comment letters per CD submitted by interest groups for IFRS 9

| Interest group | CD1 | CD2 | CD3 | CD4 | CD5 | CD6 | CD7 | CD8 | CD9 | CD10 | Total | % of total | Mean | Median | SD | Average letters per participant |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial institution | 49 | 101 | 39 | 76 | 110 | 45 | 48 | 81 | 66 | 42 | 657 | 38 | 66 | 58 | 25 | 3 |
| National standard-setter | 18 | 23 | 16 | 26 | 22 | 17 | 22 | 24 | 23 | 27 | 218 | 13 | 22 | 23 | 4 | 7 |
| Corporate | 25 | 19 | 5 | 17 | 11 | 8 | 6 | 58 | 25 | 14 | 178 | 10 | 18 | 15 | 15 | 2 |
| Association | 27 | 36 | 9 | 25 | 21 | 19 | 13 | 32 | 20 | 16 | 218 | 13 | 22 | 21 | 8 | 3 |
| Academia | 3 | 1 | 0 | 0 | 1 | 0 | 0 | 1 | 0 | 1 | 7 | 0 | 1 | 1 | 1 | 2 |
| Accountancy | 27 | 25 | 12 | 34 | 28 | 19 | 25 | 31 | 26 | 20 | 247 | 14 | 25 | 26 | 6 | 4 |
| Individual | 5 | 22 | 3 | 2 | 7 | 6 | 7 | 12 | 5 | 4 | 73 | 4 | 7 | 6 | 6 | 1 |
| Regulator | 11 | 19 | 5 | 12 | 15 | 9 | 17 | 8 | 10 | 7 | 113 | 7 | 11 | 11 | 4 | 3 |
| Total | 165 | 246 | 89 | 192 | 215 | 123 | 138 | 247 | 165 | 131 | 1711 | 100 | | | | |

*Constituent participation in the development of IFRS 13*

The response to the publication of the three CDs was 387 comment letters from 240 participants across the world including 174 (73 per cent) that also submitted comment letters during the development of IFRS 9. The main exposure draft, CD12, attracted the highest number of comment letters (160). Only 47 participants (20 per cent) submitted comment letters in response to all three CDs. The majority of participants, 140 (58 per cent), only submitted one comment letter.

Table V shows the number of comment letters submitted by each interest group in response to the three CDs published during the development of IFRS 13. It also shows the number of participants per interest group and the average number of comment letters per participant.

The overall results of the statistics are that financial institutions were the most active interest group, followed by the accountancy profession, and that the most active IASB region was Europe, followed by Asia/Oceania and North America. From this can be concluded that the most populous jurisdictions, the large economies and the jurisdictions with advanced capital markets, have been the most active participants in the IFRS standard-setting due process. As the global "soft law" that is IFRS stems from this process, it raises questions about the legitimacy of the standard-setting procedures where the smaller jurisdictions' low participation rate implies that they have little or no influence on IFRS.

## Conclusions

The main problem investigated was the legitimacy of the financial reporting "soft law" that is IFRS. The study highlighted that the IASB's role of setting financial reporting "soft law" for over 100 countries is fraught with legitimacy challenges. The legitimacy of IFRS can be enhanced by improving the standard-setting due process. Due process can be strengthened by ensuring that structures are representative of jurisdictions using IFRS and that due process procedures afford affected parties equal opportunities to influence the content of standards.

The IFRS standard-setting governance structures are currently dominated by countries that belong to the G20, the largest and most important economies in their geographic regions. The relationship between the IFRS governance structures and G20 countries means African countries, forced by circumstances to adopt IFRS, will have to depend on the sole G20 member from the continent, South Africa, for representation. Powerful stakeholders that endorsed IFRS, the EC and IOSCO have also been co-opted into decision-making structures. The impact of the current governance arrangements is that all the other countries that require or permit the use of IFRS may have to accept that the larger economies will determine the content of IFRS. Such an approach violates the practical discourse condition of the non-exclusion of those who can make a contribution.

The use of IFRS is not limited to listed companies, yet the allocation of IFRS governance seats is based on the size of capital markets. Some of the economies with large capital markets, Japan and the USA allow only limited use of IFRS. Their large market capitalisation is not a true reflection of their use of IFRS and the level to which they are affected is not the same level as poorer countries that have become totally dependent on IFRS for their accounting frameworks. The limiting of the Monitoring Board membership to capital markets regulators and the reliance on market capitalisation for allocation of governance seats therefore seems inappropriate. The

**Table V.**
The number of comment letters per CD submitted by interest groups for IFRS 13

| Interest group | CD11 | CD12 | CD13 | No. of comment letters Total | % of total | Mean | Median | SD | Participants No. | % of total | Average letters |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial institution | 36 | 40 | 26 | 102 | 26 | 34 | 36 | 7 | 64 | 27 | 2 |
| National standard-setter | 18 | 21 | 19 | 58 | 15 | 19 | 19 | 2 | 25 | 10 | 2 |
| Corporate | 16 | 17 | 8 | 41 | 11 | 14 | 16 | 5 | 32 | 13 | 1 |
| Association | 19 | 27 | 8 | 54 | 14 | 18 | 19 | 10 | 37 | 15 | 1 |
| Academia | 6 | 5 | 1 | 12 | 3 | 4 | 5 | 3 | 10 | 4 | 1 |
| Accountancy | 23 | 29 | 18 | 70 | 18 | 23 | 23 | 6 | 37 | 15 | 2 |
| Individual | 6 | 8 | 3 | 17 | 4 | 6 | 6 | 3 | 16 | 7 | 1 |
| Regulator | 12 | 13 | 8 | 33 | 9 | 11 | 12 | 3 | 19 | 8 | 2 |
| Total | 136 | 160 | 91 | 387 | 100 | | | | 240 | 100 | |

IASB should consider both the number of countries that have adopted IFRS and their GDP as a basis for determining representation.

The IFRS standard-setting procedures afford affected parties the opportunity to participate in standard-setting. However, due process procedures offer more participation opportunities to stakeholders represented on governance structures and national standard-setters with formal liaison status. The low representation of certain constituencies in governance structures is echoed in the low response rates during due process for exposing and setting standards. The willingness of the IASB to effect changes requested by powerful stakeholders demonstrates a violation of the Habermas principle of the absence of coercion other than the force of a better argument.

The IASB is dependent on G8 countries, the largest economies, and international accounting firms for financial support. All major funders are represented on IFRS governance structures. The staff of the IASB includes individuals seconded from international accounting firms, corporates and national standard-setters. The practice of secondments offer the IASB an opportunity to acquire technical expertise but the downside is that well-resourced constituents with vested interests are able to directly control the standard-setting process through secondments. The funding and staffing arrangements of the IASB compromises the integrity of due process to ensure its technical and financial viability. The arrangement leaves the IASB in a dilemma of accepting support from parties with vested interests to remain viable at the risk of being perceived by poor countries as biased toward powerful interests.

Current participation in the IFRS standard-setting process is tipped in favour of Europe. It is therefore important for other regions to mobilise their stakeholders to participate in the standard-setting due process, especially Africa and South America. These two regions should encourage constituents to participate through their regional standard-setters, industries or national associations. The concern regarding the ability of constituents' submissions to influence the IASB may affect participation levels in standard-setting projects. The low levels of African participation in IFRS standard-setting projects may result in standards that are not relevant for the region. The structural imbalances in IFRS standard-setting due process suggest that the cooperative search for the truth is not the only motive for participation. Constituents are involved in strategic actions that cause the due process to fall short of a valid practical discourse as outlined by Habermas.

Possible future research areas include a survey to understand constituents' perceptions of IFRS, assessing the relationship between the IASB and national standard-setters, especially in light of structural changes implemented, and an analysis of other participation methods. Another important research area could be the legitimacy implications of G20 countries' dominance of IFRS governance structures.

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