

The Politics of Accounting Standard-Setting: A Review of Empirical Research*

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Abstract:

We provide an overview of the empirical literature on the politics of accounting standard-setting, focusing on the U.S. Financial Accounting Standards Board (FASB). Although it is clear from casual observation that politics sometimes plays a first-order role in the determination of accounting standards, we argue that more can be done to improve our understanding of this important topic. Based on our review, we outline what we see to be a number of potentially fruitful directions for future research.

Key words: Accounting standards, FASB, Politics, Lobbying, Economic consequences.

*This is an invited review paper prepared for the Australian Journal of Management conference at the University of Melbourne in July 2013. We have benefited from the comments of participants at the conference and an anonymous reviewer. Our review is not intended to be comprehensive and as such may omit references to some important papers on this topic. Send correspondence to Skinner at dskinner@chicagobooth.edu.

1. Introduction

Accounting researchers have long been interested in the extent to which politics affects accounting standard-setting. Even casual observation of the standard-setting process suggests that politics can have a first order effect on how accounting standards are set. Beginning with Watts (1977) and Watts and Zimmerman (1978), researchers have sought to develop and test economics-based theories of standard-setting that capture these political forces. Our goal is to synthesize extant empirical research on the politics of standard-setting at the U.S. Financial Accounting Standards Board (FASB).¹ Although extant research provides useful evidence on the politics of standard-setting, we argue that our current understanding of the politics of standard-setting is relatively modest and that more remains to be done. We make suggestions for how research on the politics of standard-setting can progress in the future.

We define political influence over standard-setting as a “purposeful intervention in the standard-setting process by an economic entity with the goal of affecting the outcome of that process to increase that entity’s economic value or wealth or achieve some other self-interested purpose inconsistent with the FASB’s mission.” We are interested in all forms of political influence over standard-setting, including but not limited to lobbying. We elaborate further on this definition in Section 2.

Because our goal is primarily to review empirical research, we provide only a brief summary of different economic models of standard-setting. Accounting standard-setting is different in important ways from other forms of regulation, which means that

¹ We focus on the FASB because of its relatively long history and global importance, as well as to make the scope of our task manageable. International aspects of the politics of standard-setting are both important and interesting but are not considered here. To further limit the scope of our review, we focus primarily on large sample empirical research related to standard-setting at the FASB while acknowledging that other methods are also likely to provide important insights.

models of regulation, such as those developed in the economics literature, apply to only a limited degree in accounting. Nevertheless, such models provide necessary structure for empirical work and it would be useful to see more work in this area.²

Our main task is to summarize extant empirical research on standard-setting. We classify this research into three major categories. First, there is research on political lobbying in the standard-setting process, the most common and well-known research in this area. We summarize and review this research in Section 4. The ability of this research to explain standard-setting is limited, however, in part because lobbying in the standard-setting process only occurs once the FASB decides to add a project to its agenda, so it is clearly important to understand the forces that shape the agenda. There is limited research on agenda-setting by the FASB; we discuss this research in Section 3. Finally, other research addresses the politics of standard-setting more broadly than comment-letter lobbying; we provide a summary of this other category in Section 5. Widening the lens on this research is likely to be important if we are to fully capture political influences over standard-setting.

Our review highlights a number of limitations of extant research, which we argue provide some potentially important opportunities for future research. Because most of this research was done during the 1980s, the research was hampered by a number of constraints, some of which are less binding today. For example, early research lacked statistical power because sample sizes were small—today we have a much larger set of potential observations, in terms of (1) the number of accounting topics that have been considered by the FASB over its now 40 year history, (2) the number of constituents

² Some promising recent work along these lines includes Bertomeu and Magee (2011) and Bertomeu and Cheynel (2013).

involved in the process, some of whom are involved on an ongoing basis, and (3) the number of comment letters and other due process documents. Further, advances in information technology and textual analysis mean that it is possible to use machine-processing to analyze the large volume of data now at researchers' disposal. The FASB has retained essentially all due process documents, which provides a potentially rich set of data, most of which is largely unexplored.

This expanded research capability can address questions that will provide a richer understanding of the role of politics in standard-setting. It has long been clear (Amershi et al., 1982) that the entities with a stake in accounting standard-setting—accounting firms, corporate preparers, managers, or industry groups—are likely to play a long-run strategic game when deciding on how to engage the political process. To better understand the process, researchers will need to follow these players' actions over time and consider not only comment letter lobbying but other forms of political engagement as well.

Our hope is that this review will generate renewed interest in research on the politics of accounting standard-setting. While there are a few recent papers on this topic that use interesting new approaches (e.g., Ramanna, 2008), our view is that there are a number of potentially fruitful avenues that remain largely unexplored. Given the importance of accounting rules in the economy, something made vividly clear by the recent financial crisis, we think it is an area where more positive research can help better inform ongoing policy discussions in this area.

Section 2 provides a fuller explanation of our definition of political influence over standard-setting and an overview of how different theories of regulation apply to

accounting standard-setting. Section 3 discusses the forces that affect how the FASB sets its agenda. Section 4 summarizes extant empirical research that analyzes the effect of comment letter lobbying on standard-setting at the FASB. Section 5 discusses selected other work on the politics of standard-setting. Section 6 concludes with a summary of what we know from the extant research and makes suggestions for how research might proceed in the future to enhance our understanding of the politics of standard-setting.

2. Conceptual Backdrop

2.1 Definition of Political Influence

We define political influence over standard-setting as a “purposeful intervention in the standard-setting process by an economic entity with the goal of affecting the outcome of that process to increase that entity’s economic value or wealth or achieve some other self-interested purpose inconsistent with the FASB’s mission.”⁴

Under this view, political influence occurs when it shifts the standard-setters’ position away from what they see as the “right answer,” meaning a standard that achieves its objectives. This gives rise to the question of the objectives of standard-setting, a difficult and complex question about which much has been written (e.g., Kothari et al., 2010). We take a simple, pragmatic approach: consistent with the FASB’s stated mission, we take the view that accounting rules that: (a) move accounting to a position that is more consistent with conventionally-accepted definitions of financial statement items based on economics, (b) improve transparency, and (c) eliminate accounting alternatives that provide managers with additional flexibility in reporting, are generally

⁴ This definition is in the spirit of Schipper’s (1989) definition of earnings management. Our definition is not dissimilar to that of Zeff (2002, p. 43), who defines political lobbying on accounting standards “...to mean self-interested considerations or pleadings by preparers and others that may be detrimental to the interests of investors and other users...”

consistent with its mission.⁵ In addition, since 2001, rules that achieve convergence with the IASB are also consistent with this mission.

This definition includes direct and indirect intervention by Congress (it is unlikely that Congressional lawmakers intervene in the process unless politically influential constituents seek Congressional help to influence the FASB), government agencies such as the Treasury Department, as well as direct lobbying by managers, companies (preparers), industry associations, and other parties that is motivated by these groups' self-interests.

It can also include lobbying by accounting firms although these entities' incentives are less clear and likely to be complex. Accounting firms likely participate in the process to improve the quality of financial reporting (for example, by more clearly specifying accounting in an area of reporting that has become ambiguous) as well as to lobby on behalf of their clients—the motivation(s) for accounting firms' lobbying remains largely an open empirical question, as we discuss below. There are at least three non-mutually exclusive reasons audit firms lobby accounting standard-setters: (a) to improve financial reporting for altruistic reasons (because it's in the best interests of the profession), (b) to achieve their own self-interests (for example, to clarify and strengthen guidance in a particular area to reduce audit costs, including expected litigation costs, or

⁵ Consider the recent discussions about proposed new accounting rules for leases. At the risk of oversimplification, current FASB/IASB proposals would capitalize most lease transactions, including those that are currently treated as operating leases and so largely off-balance sheet. To the extent that most neutral observers see this approach as an improvement in accounting (because the economic substance of many leases currently treated as operating leases is that they are asset purchases financed by debt), efforts by the leasing industry to preserve the status quo can be viewed as political lobbying. See, for example, the IASB chairman's recent speech on this topic, available at <http://www.ifrs.org/Alerts/Conference/Pages/HH-speech-LSE-November-2012.aspx>. Whether such an approach (to eliminate alternative accounting treatments for a given class of transaction) is economically efficient is unclear—if one believes managers make accounting choices to signal private information, eliminating their ability to innovate and report transactions in a manner most consistent with the underlying economics potentially reduces the informational value of accounting information, a point long recognized in the literature (e.g., Holthausen and Leftwich, 1983).

to lobby for rules that increase the demand for auditing work); (c) to lobby on behalf of their audit client(s) for the clients' self-interested purposes. We do not view (a) as political lobbying because its purpose is consistent with the FASB mission (even though different parties may have different views about how to improve financial reporting in a particular instance).

The SEC's influence over the process is also complex and difficult to characterize in simple terms. In some cases, the SEC has responded to pressure from Congress or other government agencies to intervene in the standard-setting process. However, the SEC often works to achieve goals consistent with those of the FASB, at least to the extent that those goals align with those of the SEC (the SEC's mission is essentially to "level the playing field" for investors). The SEC has at various times supported the FASB when it has faced political pressure and periodically takes action on accounting matters in a manner that seems consistent with the FASB's mission.⁶ While sometimes designed to force FASB action (as was the case with software development costs in 1983, discussed below), these actions are not obviously political in the sense that the SEC seeks to advance the agenda of some interested party. For example, SAB 101 was designed to reduce firms' ability to manage earnings after the perceived revenue recognition "excesses" of the 1990s and so to improve financial reporting.⁷

On the other hand, being a government regulatory agency, the SEC can face political pressures that force it to take positions inconsistent with those of the FASB.

⁶ For example, Bob Herz describes how the SEC strongly supported the FASB during the political battle over accounting for employee stock options (ESOs) in 2004 (Herz, 2013, p. 79).

⁷ SEC Staff Accounting Bulletin No. 101—Revenue Recognition in Financial Statements (SAB 101) provides detailed guidance on revenue recognition and while held out as not changing GAAP, in fact resulted in many companies changing their revenue recognition practices, and generally resulted in more conservative revenue recognition practices. For more discussion of SAB 101, including its motivation (part of SEC Chairman Arthur Levitt's campaign against earnings management) and effects, see Altamuro, Beatty, and Weber (2002).

One clear example here is the SEC's decision, made under intense political pressure, to effectively override SFAS-19 in the late 1970s and allow oil and gas companies to use either the full cost or successful efforts methods of accounting for exploration and development costs when the FASB rule (SFAS 19) had outlawed full cost accounting.⁸ Moreover, because the SEC chair and commissioners are political appointments, its views on standard-setting are unlikely to be consistent over time and will reflect the views (and perhaps political persuasions) of the commissioners of the day.

2.2 Models of the standard-setting process

This section briefly describes major theories of regulation as well as how well these theories apply to accounting standard-setting, which is different in some important respects from other forms of regulation. This section is not intended to be in any way comprehensive; rather, the goal is to give the reader an overview of extant theories as a basis for understanding extant empirical work.

Economic theories of regulation generally envision regulators as direct political appointments who make decisions that affect the allocation of wealth between producers in a given industry and the associated customers. For example, regulators of electric utilities set the prices that consumers pay for electricity. The FASB, however, is organized as an "independent" standard-setter not directly affected by the political process. Both Congress and the SEC support this position. The SEC reaffirmed the FASB's role as the accounting standard-setter for public companies in 2003, and Congress strengthened the FASB's independence by establishing a mandatory funding

⁸ See Collins and Dent (1979) and Zeff (2005) for more detailed accounts of how political pressure resulted in the SEC effectively circumventing SFAS-19.

mechanism as part of the Sarbanes-Oxley legislation passed in 2002.⁹ This means that accounting standard-setters like the FASB differ from other types of regulators in some important ways, which affects the applicability and descriptiveness of general economic theories of regulation.¹⁰

One model of standard-setting is the Public Interest model (e.g., Posner, 1974). Under this model, standard-setters are benevolent in the sense of making decisions that are socially efficient. Regulation exists to solve some type of market failure or externality in markets. In the case of accounting standards, the usual justification is that accounting rules are public goods that are under-produced in unregulated markets.¹¹

While setting accounting standards using such a model is not without complication—it is hard to know what accounting standards unambiguously maximize social welfare (e.g., see Sunder, 1988)—this model is descriptive to the extent that accounting standard-setters are genuinely interested in improving financial reporting (usually taken to mean increasing transparency and reducing the accounting choices available to management, which they perceive as an appropriate objective).¹²

Another possible model is Regulatory Capture (e.g., Stigler, 1971; Peltzman, 1976). Here the notion is that firms in the industry being regulated “capture” the regulator who makes regulatory decisions that are in the firms’ (industry’s) best interests, as opposed to being socially efficient. As discussed below, this model has been tested in the context of accounting standard-setting. Some argue that the Big 8 accounting firms

⁹ In addition, the FASB is governed by the Financial Accounting Foundation (FAF), a body which effectively shields the FASB from political influence and protects individual board members from direct political threat (politicians cannot fire FASB board members, who are appointed by the FAF). Of course, the FAF is itself subject to political pressures.

¹⁰ Our discussion here relies in part on Kothari et al. (2010). The interested reader is referred to that paper for more details and references.

¹¹ For example, see Gonedes and Dopuch (1974). For a critique of this view, see Leftwich (1980).

¹² Given what standard-setters say they do (e.g., Beresford, 1997; Herz, 2013), there is support for this idea.

effectively controlled the decisions of the FASB, either to pursue their own self-interests or on behalf of their clients (e.g., U.S. Congress, 1976). However, FASB rules affect many different types of entities (the Big 4 audit firms, other audit firms, users of financial statements such as analysts, as well as firms across many different industries) with divergent interests, so it is not clear exactly who “captures” the FASB, a point we discuss further below.

Watts (2006), drawing on much of his previous work, argues that the FASB determines accounting rules as part of a market-driven process. Under this view, the set of accounting rules is a malleable set of best practices that achieves financial reporting objectives by balancing the different market-based objectives of general purpose financial reporting (such as the use of financial statements for contracting, for investment and valuation, for regulation, and so on). Watts views political forces as playing two distinct roles in standard-setting. First, political forces reflect changes in the underlying economic, legal, and institutional environment, and as such help move accounting standards towards the market equilibrium. Second, political forces can also be driven by special interest groups seeking to affect accounting rules for self-interested reasons, pushing the set of rules away from the economically-efficient equilibrium. This second role fits our definition of political lobbying. However, it seems likely that both forces are at play in standard-setting although Watts’ first point has received less attention in the literature perhaps because it is more difficult to test in large sample studies.¹³

Yet another model is Ideology, the idea that standard-setters have particular ideologies or beliefs that underlie their decisions (e.g., Kau and Rubin, 1979; Kalt and

¹³ Qualitative descriptions of how the FASB determines its agenda, such as Johnson and Swieringa (1996), Howieson (2009), and Herz (2013) support the idea that the underlying economic and political environment of the day affects agenda-setting at the FASB in important ways.

Zupan, 1984). While the economics literature often views ideology as a particular political persuasion (for example, regulators are either Democrats or Republicans) there are a wide range of possible ideologies including those that encompass particular “world views.” In accounting we might view the use of fair value numbers and a balance sheet approach as ideologies that affect accounting rules. To the extent that standard-setters have an ingrained mindset that favors rules with certain characteristics, this can be viewed as an ideology.¹⁴

We might also consider a Regulatory Model of accounting rules. Ball (2009) argues that US GAAP has become more rules-based over time as standard-setting has moved away from its 1930s roots (as an amalgam of best practices, as suggested by Watts) towards a regulatory-driven process that is heavily influenced by the SEC and, more generally, by securities regulation. This view explains why some take the view that US GAAP has become more of a “compliance exercise” and increasingly “rules based” over time. Ball views this trend as being responsible for the accounting scandals of the early 2000s.

Overall, no one model fully captures the complex economic and political nature of accounting standard-setting, in part because accounting standard-setters are held out to be independent while at the same time operating under the direct oversight of the SEC and Congress, a delicate balancing act. Nevertheless, these models provide a useful framework for empirical work. The danger, however, is that researchers “overfit” the data by interpreting empirical evidence as being consistent with a favored model, a

¹⁴ This notion might be useful in understanding the rise of fair value accounting over the last 20 years. To the extent one agrees with Watt’s (2006) perspective that fair value rules generally are inconsistent with efficient contracting and do not reflect the economic efficient set of accounting rules, ideology may offer a useful way of understanding the apparent preference of influential accounting standard-setters for fair value-based rules.

particular problem when the mapping from models to hypotheses to data and testing is not very strong. We discuss challenges related to the fit between theory and empirical work further below.

3. The agenda of standard-setters

A crucial determinant of accounting standards is how particular accounting issues get included on the standard-setters' agenda, yet we have little evidence on the economic and political forces that determine which projects the FASB decides to take on.¹⁵ Beresford (1993), at the time the chairman of the FASB, said the following: "I continue to believe that agenda setting is the single most important decision that we make at the FASB. Yet, for all the care that goes into this process, it may be one of our least understood...activities (p. 70)."

As far as we are aware, only two studies use large sample empirical evidence to investigate how the FASB's agenda is set (Leftwich, 1995; Allen, 2013).¹⁶ Leftwich (1995) indicates that potential agenda topics come from at least four sources: (i) the Financial Accounting Standards Advisory Committee (FASAC) through an annual survey; (ii) the Emerging Issues Task Force (EITF); (iii) meetings of the board with constituent groups, including the SEC, and (iv) unsolicited correspondence from various parties. Howieson (2009) indicates that the sources of agenda projects are "many and varied" and include these formal mechanisms as well as many informal sources, including staff monitoring of the business press as well as the Board's interactions with preparers and auditors.

¹⁵ Walker and Robinson (1993) also make this point but we think it bears repeating some 20 years later. Howieson (2009) provides a detailed summary of anecdotal evidence on the FASB's agenda-setting process as well as useful institutional detail on the criteria used by the FASB in setting its agenda.

¹⁶ The Leftwich (1995) paper is cited here although it is still in working paper form and labeled 'preliminary and incomplete.' It is nevertheless useful given the dearth of research on this topic.

As Leftwich points out, agenda setting is more than simply identifying topics that the board will work on—part of this process is also to determine the scope of a project, which likely impacts the nature of the accounting standard that will ultimately be forthcoming. By defining a topic narrowly, it is more likely to quickly result in agreement and a final standard; by defining a topic broadly, it is likely to take longer and be more controversial because it is then likely to have wider financial reporting ramifications and affect a wider array of constituents.

Leftwich includes the influence of the SEC under (iii) here and argues that the SEC is likely to have an important influence on standard-setting. Leftwich provides the example of the SEC placing a moratorium on the capitalization of software development costs (which at that time was permitted by GAAP) in 1983, at which time it “strongly encouraged” the FASB to undertake a project on this topic.¹⁷

The FASB’s decision to consider accounting for business combinations in the late 1990s illustrates the difficulty of untangling the forces that lead the FASB to add items to its agenda. As discussed by Ramanna (2008, p. 256) and Zeff (2002, p. 50), this project was added to the FASB agenda as a result of SEC pressure, largely due to the increase in the number of pooling-of-interests transactions during the 1990s and the inordinate amount of SEC staff time that was devoted to making determinations as to the suitability of this accounting method, so one interpretation is that “political” lobbying was at play.¹⁸ However, this issue was also receiving international attention at this time through the

¹⁷ SFAS 86 (“Accounting for the costs of computer software to be sold, leased, or otherwise marketed”) was issued by the FASB in August 1985. The appendix to that standard (paragraph 18) describes the April 1983 SEC moratorium in its “background information” as well as the fact that the SEC moratorium would be lifted when the FASB provided guidance, making it clear that the SEC forced the issue onto the FASB agenda.

¹⁸ To achieve pooling, firms had to demonstrate that transactions satisfied a certain set of criteria, and typically sought SEC clearance that the criteria would be satisfied before going ahead with the transaction.

G4+1, an international group of standard-setters (which included Australia, New Zealand, the UK, the US, and the IASC) and so the desire to converge US GAAP with international practice also likely affected the decision to put business combinations on the agenda.¹⁹

The Business Combinations case offers an interesting counterexample to the idea that the FASAC survey results are important in determining the FASB agenda. As Leftwich discusses, this topic was at the top of the FASAC survey (indicating that the FASAC members considered it the highest priority standard-setting issue) for four consecutive years, from 1990-1993, and yet was not added to the agenda until later in the decade. It is not clear why the FASB apparently ignored or postponed consideration of this issue. One possibility is that the FASB knew, based on the experiences of its predecessor body, that the issue was likely to be difficult to resolve and so deferred consideration.²⁰ Another possibility is simply that other more pressing issues fully occupied its resources. In general, we do not have much (if any) reliable evidence on the relative importance of these different considerations.

Leftwich provides a descriptive analysis of 300 FASB agenda decisions over 1978 to 1995, and reports that the FASB decides to add a project to the agenda in 39% of these cases. Leftwich then coded each of the 300 issues in a number of ways (breadth of topic, broad topic area, likely accounting effect) but was unable to discern any clear patterns that would help explain the process.

¹⁹ The FASB issued an Invitation to Comment entitled “Methods of accounting for business combinations: Recommendations of the G4+1 for achieving convergence” in late 1998.

²⁰ See, for example, Zeff (1972, pp. 212-216) for the political firestorm that surrounded the Accounting Principles Board’s (unsuccessful) attempt to do away with pooling.

Allen (2013) is perhaps the only other empirical archival paper to analyze agenda setting at the FASB. Allen focuses on one aspect of agenda-setting—the influence of the FASAC through the annual survey mentioned above. This limits the study to the extent that other determinants of agenda-setting also play a significant role. Allen provides evidence on the determinants of over 300 FASB agenda decisions over 1982-2006 although the survey format changes in 2002, so there are two “regimes.”

Allen documents two main findings. First, she finds that constituents (members of the FASAC) do affect the FASB agenda: she finds that FASAC survey results are related to FASB agenda decisions. This is perhaps not surprising but is useful to know nonetheless (it is possible that the FASB ignores the FASAC, as implied by Leftwich’s anecdote on business combinations). Second, after classifying FASAC members into three groups—auditors, preparers, and financial—she finds that auditors and financial constituents are influential over 1982-2001 and that financial constituents are influential over 2002-2006.²¹ This finding is related to that in Allen and Ramanna (2013), discussed below, regarding the influence of the financial community on standard-setting.

It seems likely, perhaps even self-evident, that underlying economic, legal, and political forces are likely to have first order effects on the agenda of standard-setters, something about which we have little formal evidence. This point has been made by numerous papers; we mention a few representative examples. Watts (2006) discusses political and legal forces as part of the overall market process through which accounting standards evolve; this perspective is generally consistent with what we observed in oil and gas, ESOs, and business combinations, discussed further below. A similar

²¹ Financial constituents are defined as those from the banking, insurance, or securities industries. Allen indicates that it is unclear whether these constituents are acting as users or preparers of financial statements.

perspective is offered by Ball (2009), who discusses the relation between the political/regulatory process and the market for corporate governance and financial reporting in the wake of the accounting scandals in the US circa 2001.

Bertomeu and Magee (2011) focus on the financial sector to model the relation between economic cycles and political intervention in standard-setting. The basic idea in this paper is that as economic conditions decline, political forces align to weaken financial transparency, which allows more bad loans to be made.²² The subsequent recession leads to pressure for increased transparency, causing an adjustment in economic activity. These forces then weaken as the economy improves.

It seems likely that political forces generally play an important role in agenda setting at the FASB and that this operates more broadly than simply being manifested through the opinions of FASAC members (although the views of the FASAC are also likely to reflect the important economic and political forces of the day). For example, the two most important and controversial accounting issues of the 1970s—oil and gas accounting and inflation accounting—were likely added to the agenda because they were closely tied to the biggest political and economic issues of that time—the Arab oil embargo and the subsequent spike in inflation. Oil and gas accounting was directly placed on the FASB agenda by an act of Congress.²³

As another example, the business combinations/goodwill topic mentioned above was added to the agenda in the late 1990s at least partly as a result of SEC pressure, which reflected the economic forces of the day. There was a boom in M&A activity as

²² In this model, the standard-setter simply aggregates the “votes” (preferences) of its constituents, and issues accounting rules accordingly.

²³ Collins and Dent (1979, p. 4) describe the fact that the Energy Policy and Conservation Act of 1975 mandated that the SEC establish uniform accounting rules for the oil and gas industry, essentially forcing the FASB to act.

U.S. stock prices increased during the 1990s, a related increase in the fraction of stock-for-stock (as opposed to cash) deals, and so an increased demand for pooling treatment, which in turn put pressure on the SEC's limited staff resources.²⁴ This parallels the APB experience of the 1960s—it was the merger/conglomerate boom of that decade that led the APB to consider business combinations/goodwill, and which ultimately led to its demise.

The FASB's decision to reconsider accounting for ESOs in the early 2000s provides another illustrative example.²⁵ Herz (2013, Ch. 3) describes two primary forces behind this agenda decision, which the FASB knew would face significant political opposition. First, international convergence was one of the key objectives of the FASB by this time and the IASB had begun consideration of its own share-based payments project in 2001, soon after its inception.²⁶ Second, the accounting scandals of 2001-2002 led to claims that the growth of option-based compensation for executives, including its favorable accounting treatment, was partly responsible for the accounting failures. This led to calls for changes in accounting for ESOs. Finally, in the latter part of 2002 and early 2003 a large number of companies announced that they would voluntarily recognize an expense for the fair value of stock options (Aboody, Barth, and Kasznik, 2004).

²⁴ The SEC's Chief Accountant had indicated that his staff spent 40% of their time interpreting the pooling criteria (Beresford, 2001).

²⁵ The FASB's original decision to look into the employee stock options issue is also instructive. According to Dechow et al. (1996), the FASB took up the issue in 1984, apparently due to the availability of option pricing models and the increased use of fixed stock option plans and perceived deficiencies in APB-25 (1972). However, work was set aside in 1988 to work on a broader liabilities versus equity project. In early 1992, Carl Levin, a prominent U.S. senator, was concerned with extent to which stock options were being used to increase executive compensation and suggested that unless the FASB or SEC took action on the issue, he would legislate a charge to earnings. He later introduced an Act along these lines. The FASB began work on the project in early 1992 and issued an ED in June 1993. The irony, of course, is that political forces in Congress later aligned against expensing the cost of employee stock options.

²⁶ Herz was appointed FASB chair in 2002, and convergence was one of the major strategic objectives he set for the board. The Norwalk Agreement (under which the FASB and IASB agreed to work together on standard-setting) was finalized in October 2002.

Overall, it seems clear that economic, institutional, and political factors play an important role in agenda-setting at the FASB. While anecdotal observation of certain critical agenda decisions—such as oil and gas accounting, business combinations, and employee stock options—makes this clear,²⁷ we have little in the way of systematic empirical evidence on how accounting standard-setters’ agenda is determined in a more general sense.

4. Research on lobbying during the standard-setting process

Watts and Zimmerman’s seminal work on the economic consequences of accounting rules²⁸ spawned a large number of empirical studies on lobbying during the standard-setting process, which we summarize and discuss in this section. Most of this research occurs in the 1980s with relatively little work after this time, something that we discuss in evaluating this research at the end of this section. Most empirical research in this area is based on lobbying through comment letters by companies and managers (“preparers”) on proposed accounting rules, typically discussion memoranda, exposure drafts, or “preliminary views” documents; we summarize this research in Section 4.1. A more limited set of papers examines lobbying by accounting (audit) firms and other entities; we summarize this research in Section 4.2. Section 4.3 summarizes other (than comment letter based) empirical research on lobbying.

4.1. Comment letter lobbying by companies (preparers)

Watts and Zimmerman (1978) builds on earlier work by Watts (1974, 1977) to present what the authors call a positive theory of accounting standard-setting. In terms of theory, they develop the now-familiar economic consequences arguments and use those

²⁷ See Howieson (2009) for further anecdotal evidence on agenda-setting at the FASB.

²⁸ See Watts (1977), Watts and Zimmerman (1978, 1979, 1982, 1983, 1986, 1990).

arguments to develop predictions about how companies lobby (see, for example, Holthausen and Leftwich, 1983; Watts and Zimmerman, 1986). They argue that firms that are exposed to regulatory and political pressures (large firms) are more likely to lobby for accounting rules that reduce income, as lower reported profits reduce the likelihood of adverse political actions. In contrast, firms that are not subject to such exposures are more likely to lobby for accounting rules that increase reported income under the bonus plan hypothesis.

Watts and Zimmerman test these ideas using comment letters that respond to a February 1974 FASB discussion memorandum that proposed reporting the effects of general price level (GPLA) changes in financial statements (as supplemental disclosures). A total of 133 entities filed comment letters in response to this document. The authors focus on 53 companies that submitted comment letters and introduce an assumption (common to subsequent work) that the comment letters reflect the position of corporate management, which acts to maximize value for shareholders as well as its own self-interest.

Watts and Zimmerman first classify companies' comment letters responses into "yes" and "no" votes (for or against the proposal) and estimate the likely effect of GPLA on these firms' reported income. They find that of 26 firms for which income would likely decrease under the proposed statement, 8 voted yes and 18 voted no; and that the 8 yes votes came from larger firms, consistent with the political costs hypothesis. Of the 8 firms with likely income increases or no change, 7 voted no. The general tenor of these results is confirmed in their multivariate analysis, in which the interaction between firm size and the sign of the effect on earnings is positive and highly significant (implying that

larger firms whose earnings would decline support the proposed rule) results that are generally consistent with their predictions. However, other results were less strong, likely due to the relatively small sample size and lack of power, a common problem in these studies.

Watts and Zimmerman's general approach was followed in a large number of subsequent papers. Rather than discussing these papers individually, we present a summary in Table 1, and discuss representative papers to illustrate key points.

Kelly (1982) adopts an approach similar to Watts and Zimmerman to study comment letter lobbying by firms in response to the FASB's 1974 exposure draft on accounting for foreign currency translation (part of the due process that resulted in SFAS 8, "Accounting for the translation of foreign currency transactions and foreign currency financial statements," issued in 1975). Kelly uses a sample of 52 companies, 14 of which oppose the exposure draft position, to examine whether lobbying positions were related to management compensation plans, leverage, management ownership, and size (the typical economic consequences proxies). She is unable to find much in the way of results, perhaps because of limited power. In a follow-up paper, Kelly (1985) examines the characteristics of firms that choose to lobby on this exposure draft by comparing them to firms that did not lobby. Once again, the study is hampered by small sample size (there are at most 38 firms in the various lobbying subsamples). The only robust finding is that lobbying firms are larger than firms that do not lobby, a consistent result in this literature (most of the firms in the Watts and Zimmerman sample were also very large).

Francis (1987) looks at lobbying on FASB due process documents that resulted in SFAS-87 ("Employers Accounting for Pensions", issued December 1985). The FASB

initially issued a Discussion Memorandum (1981) followed by a Preliminary Views (1982) and then another Discussion Memorandum (1983). The latter two documents attracted over 500 comments letters. They were followed by an Exposure Draft in 1985 that resulted in another 400 comment letters. Notice the extended nature of the process here—the FASB sought comments on four different due process documents, each of which generated a relatively large number of comment letters, before issuing a final standard. These facts alone would seem to be informative about the process through which standards are set.²⁹

The Francis study looks at comment letter received in response to the Preliminary Views document. The proposed rule had two main features, neither of which was appealing to companies, which had formerly accounted for pensions on a cash basis: (a) recognition of pension assets/liability on the balance sheet, including over/under-funding; (b) recognition of a standardized pension expense. The document resulted in over 500 comment letters, of which 319 were from industrial companies (financial and insurance companies were excluded), the vast majority of which opposed the new rule.³⁰ The final sample comprised 218 companies for which Compustat and pensions data were available (the latter were taken from what the author refers to as the “FASB 36 Data Tape”). The author uses a comparison sample of 582 non-lobbying firms for which Compustat and pensions data are also available.

²⁹ As we suggest below it seems like this type of information—the number of due process documents, the length of the FASB process, and the intensity of lobbying on the various documents—is informative about the nature of the political process.

³⁰ In addition to these comment letters, Francis indicates that there were 37 presentations to public hearings. These presentations are not usually considered by researchers and, while it seems likely that most opinions expressed at those hearings are similar to those in comment letters, there is little or no evidence of which we are aware on the content of these presentations.

The author's main analyses consist of logit regressions designed to model firms' decisions to lobby (a 0/1 variable) as a function of firm size, as well as the likely balance sheet and income statement effects of the rule. The author finds that larger firms and firms with larger (adverse) financial statement effects of the rule are more likely to lobby against the proposed rule although the income statement effect is weaker than the balance sheet effect. These results indicate that, generally, larger firms are more likely to lobby than smaller firms and that firms lobby when they are likely to suffer adverse financial reporting consequences of the new rule.

One of the most controversial accounting issues addressed by the FASB was oil and gas accounting. As discussed above, this issue was effectively added to the FASB agenda by Congress, and the standard ultimately promulgated by FASB was famously overridden by an SEC rule that reinstated the full cost method, one of the rare instances when the SEC has usurped the power of the FASB to set accounting rules. So it is clear that this issue was of great political interest, which makes it a good candidate for study.

An important methodological issue in these studies is that the authors generally restrict their samples to firms that choose to lobby as part of the comment letter process, which is clearly subject to selection effects. One obvious point is that firms that choose to lobby are a relatively small subset of all firms that will be affected by the rules, so it is unclear how representative their votes are likely to be.

Deakin (1989) is thus notable from a methodological standpoint because he studies firms' incentives to lobby on oil and gas accounting and starts with a FASB list of *all* 137 publicly-listed U.S. firms that used the full cost (FC) method; that is, he has the full set of firms that would be affected by the new rule. Deakin analyzes factors

associated with lobbying by FC firms with available financial statement data on: (a) the December 1975 FASB discussion memorandum (27 firms lobby; 67 do not), (b) the June 1977 FASB exposure draft (51 firms lobby; 67 do not), and (c) before the SEC in March 1978 (50 firms lobby; 68 do not), and so covers a relatively complete part of the process. In the main analysis, the author estimates three logit regressions that collectively support the idea that lobbying is driven by management compensation plan and debt contracting incentives, as well as by the level of the companies' oil and gas exploration activities, and so is largely consistent with an economic consequences view of lobbying. The author's results are relatively strong perhaps due to two aspects of the design/setting: (a) the oil and gas issue was clearly an important economic and political issue at the time, and (b) the availability of the full set of FC firms and the decision to examine their participation in several stages of the lobbying process.

As a final example, Dechow et al. (1996) examine characteristics of firms that lobby on the 1993 FASB ED on accounting for ESOs. They find that the likelihood of submitting a comment letter opposing the expensing of stock options is strongly related to the use of stock options in top executive compensation, including the level of that compensation. The authors conclude that executives were likely worried about public scrutiny of their relatively high levels of stock-based compensation. Also, they find that the "cost of capital" argument put forward in these letters is an excuse to disguise the executives' self-interested concerns.

This study is noteworthy relative to prior work in at least two respects. First, most previous research documents political lobbying by managers on behalf of their firms (shareholders); for example, the political costs argument is about reducing firms'

exposure to the political process, and so reducing the present value of expected political losses to shareholders. In contrast, Dechow et al. present evidence of management lobbying directly in its own self-interest. Second, they report that the FASB received more than 1,700 comments letters on the ED, of which the authors analyzed 347 from companies, all of which opposed the ED position (they exclude Berkshire Hathaway, the only company to support the proposal). Of the other comment letters, 953 were form letters (the same letter received from different entities), a phenomenon that may be interesting in its own right as a form of lobbying.

The studies summarized to this point provide evidence on lobbying by preparers (companies or managers). We next discuss lobbying by other parties.

4.2 Lobbying by other parties, including audit firms

Early studies by Brown (1981) and Haring (1979) provide examples of a more general approach to lobbying research in two respects: they include all comment letter respondents (not just companies/preparers) and analyze a sequence of important standard-setting issues rather than just a single event. Both papers were motivated by concerns raised by Congress in the mid to late 1970s (the Metcalf report (U.S. Congress, 1976)) that the FASB was unduly influenced (“dominated”) by the Big 8 and the AICPA, who were in turn dominated by their clients. Both papers take a broad, descriptive approach to this question and use data made available by the FASB as part of its response to the Metcalf report.

Brown (1981) makes a number of design choices that distinguish his work from other papers in this genre. First, he analyzes a sequence of nine “primary” topics considered by the FASB as of the time he did his analysis (over the period from 1974 to

1977). Second, he focuses only on those respondents that commented on at least seven of the nine projects, and so were consistently involved in standard-setting. 27 respondents met this criterion, including the Big 8 accounting firms, various professional and business groups (including the Financial Executives Institute, the AAA, the AICPA), and a small set of large companies (including GM, Shell, du Pont, Aetna Life & Casualty, GE, and Exxon). Third, he focuses on responses to FASB discussion memoranda on each of the topics, and in particular on the five or six specific questions raised in each of the documents, yielding a total of around 50 questions on which the FASB sought input.

He then uses a form of multidimensional scaling to plot, in two dimensions, the relationships among the preferences of the respondents as revealed by their responses, as well as the FASB position. The idea is essentially the opposite of the approach taken in much subsequent work. That is, he takes no strong position regarding how to code positions in the FASB documents or responses to those documents but instead takes a very open-ended approach to try and get a sense for the general relationship of responses across responders.

Three useful findings emerge from Brown's analysis. First, there is some commonality among the positions of each of the two main groups of respondents—the audit firms on the one hand and the preparers on the other. Second, there are no strong or consistent coalitions among the constituents—the alignments vary across the projects, suggesting that substantive issues related to each of the projects dominate any underlying and ongoing standard-setting preferences of particular respondents. Third, Brown finds that the FASB's position is not strongly or consistently related to that of any particular

group of respondents, inconsistent with Congressional concerns that the FASB was unduly influenced by a particular constituency such as the Big 8.

Haring (1979) takes a similarly agnostic approach and uses the same type of data to examine associations between the positions expressed by the FASB, the accounting firms, and their clients. Like Brown, Haring finds little evidence that the views of accounting firm clients affect either the accounting firms' lobbying positions or the FASB position. However, he does find some relation between the FASB position and those of the accounting firms, as well as between the FASB position and those of its sponsoring entities (which include the AAA, the AICPA, and the FEI).

Watts and Zimmerman (1982) explicitly examine the relation between lobbying by auditors and their clients. Their interest is also to investigate the claim in the Metcalf report that auditors are captured by their clients, and so lobby directly on their behalf. Watts and Zimmerman advance the alternative hypothesis that audit firms also lobby directly in their own self-interests, which may partially overlap with that of their clients. They then look at evidence from auditor and client lobbying on six accounting issues decided by the APB and FASB in the 1960s and 1970s, selected based on whether the major (Big 8) firms were divided in their positions, whether there were at least 50 auditor client submissions, and whether they could obtain data on the submissions.³¹

Perhaps the most important finding is that the audit firms did not automatically vote their clients' preferences and on some occasions took positions opposite that of the majority of their clients (for example, Arthur Andersen supported the FASB position on lease accounting even though the large majority of its clients opposed this position).

³¹ Note that in the case of the APB issues (the Investment Tax Credit decisions in 1962 and 1971) audit firm partners voted directly because they sat on the board itself.

They also find that variables that proxy for auditors' incentives have significant explanatory power after controlling for client firm incentives, which suggests that auditors lobby directly in their own self-interests as well as those of their clients.

Puro (1984) also provides empirical evidence on lobbying by auditors. To do this, she investigates two broad predictions, similar to Watts and Zimmerman (1982). First, she examines predictions whether audit firms lobby in their own self-interests (regulatory capture). Second, she examines the prediction that auditors lobby on behalf of their clients' economic interests under conventional economic consequences arguments.

To perform the empirical analysis, she classifies accounting rules into two broad groups: those that require auditors and their clients to make new disclosures (such as inflation-adjusted financial statement numbers) and those that restrict accounting choice by eliminating some clients' preferred accounting methods. The idea is that audit firms benefit from standards that impose new requirements because this increases the demand for their services (she discusses how these standards may favor larger audit firms given the fixed costs involved in new audit work). She also examines standards that limit accounting choice, which are likely to be costly to audit firms whose clients have preferred accounting methods that the proposed rule would eliminate.

To investigate these predictions, she looks at lobbying on six exposure drafts, chosen to represent both types of standard (on the former, general price level accounting, leases, marketable securities, and segment reporting; on the latter, oil and gas, and foreign exchange). She then collects comment letter data for the 41 audit firms that lobbied on at least one of these exposure drafts, as well as data on around 2,100 of these

firms' client companies for which she was able to locate financial statement information (including the approximate financial statement effects of the various standards on these companies).

Rather than simply coding comment letters as “for or against” a particular exposure draft, Puro recognizes that comment letter positions are often more complicated, and instead first arrives at a single key accounting question raised by each exposure draft (e.g., should foreign exchange gains and losses be included in income? should all oil and gas firms be required to use successful efforts accounting?). She then codes audit firms' comment letter responses to these questions as for, against, or neutral.

Puro develops testable hypotheses about lobbying by both the audit firms directly in their own interests as well as on behalf of their clients, aggregating the financial statement effects on client firms by audit firm.

The empirical analysis first involves the estimation of a series of multinomial probit regressions, estimated separately for each accounting issue, where the dependent variable is the audit firm's lobbying position (coded as for, against, or neutral). The independent variables are proxies for the various lobbying incentives, divided into two groups based on whether they proxy for the audit firms' direct incentives (“regulation view,” such as whether the proposed rule will increase their work, whether they specialize in clients that use accounting methods the rule would ban, and size) as well as the incentives of the firms' clients (“agency view,” such as the income effect of the rule for clients, the fraction of clients that lobby, etc).

Overall, Puro finds more support for the regulation view than for the agency view, especially for those rules that increase auditors' work, although there is some evidence

for the agency view on the other accounting rules. These results are largely consistent with those of Watts and Zimmerman (1982) in that they indicate that audit firms lobby directly in their own interests as well as in the interests of their clients.

The only other paper that focuses specifically on lobbying by auditors is a recent working paper by Allen, Ramanna, Rowchowdhury (2012). The main idea in this paper is to examine how changes in the structure of the audit industry, in particular the “tightening” of the Big 4 oligopoly, affect the way those firms lobby in the standard-setting process. The basic argument is that increasing litigation costs and political costs over the period during which the tightening occurred make these firms more likely to lobby for rules that increase the reliability of financial reporting (although the authors indicate that there is a countervailing force—the increased concentration has made the remaining firms more secure, making it less clear that they prefer more reliability).³²

While the lobbying behavior of these firms is of interest, it is not clear why the authors focus on reliability when, as discussed in the context of Allen and Ramanna (2013) below, other issues are likely to be more salient in the context of any given accounting topic.³³ This was apparently a pragmatic choice made in response to the need to characterize all FASB topics along a single dimension (relevance versus reliability), an important design consideration in this research. Another interesting question is the extent to which these firm lobby on behalf of their clients, something the study does not address

³² It is also unclear how to think about causality here—perhaps the changing regulatory and political environment drives both increased concentration and the change in lobbying incentives.

³³ As one example, in the ESO debate, the main issue was whether the cost of stock options should be expensed. And while reliability of the fair value computation was an issue (it is difficult to recognize a number that is not reliably measured), it was not the main focus of the debate and could even be characterized as an “excuse” that was used by opponents of the rule to argue against recognition.

but that was an important issue in the early work discussed above (and that we discuss again below).

The authors interpret their results as implying that the firms' increased visibility over time, combined with less concern about their clients' preference for financial discretion, has led the firms to lobby more strongly against standards they perceive will result in lower reliability.³⁴

4.3 Other forms of political lobbying

Two more recent papers expand the scope of this research by examining the role of Political Action Committees (PACs) in accounting standard-setting. Farber, Johnson, and Petroni (2007) examine the use of PACs to lobby Congress. In particular, they look at lobbying on an Act passed by the U.S. House (but ultimately not the Senate) which would have limited the reported ESO expense to options issued to the top five executives and valued those options using the minimum value method. This rule would have resulted in a reported expense substantially lower than that ultimately recorded under SFAS-123 (which uses the fair value method and covers all employee stock options).

Farber et al. examine 400 firms with a total of 449 active PACs. Among other things, they find that the bill was most strongly supported by Republicans. They do not find a relation between the number of employees working in sample firms that are both headquartered in a representative's constituency and in the top quartile of options issued in 2003 and the politicians' voting on the bill. They do find a relation between PAC

³⁴ Two questions arise regarding the authors' interpretation of this evidence. First, at least in the U.S., the Big N audit firms have had a large amount of political visibility and exposure since the 1970s, so it is not clear that their political sensitivity has increased in any economically important way over time. Second, it would be useful to know more about the mechanism through which standards that increase reliability relative to relevance help mitigate Big N exposure in the political process (perhaps the argument is that this lowers the likelihood of accounting scandals).

contributions and voting but this could simply be because Republicans receive more contributions generally. Their main finding in multivariate analysis is that PAC contributions are related to firms' overall options position (that is, the overall effect of the expense), so firms contribute more when there is more at stake.

Ramanna (2008) looks at a number of aspects of the politics of the FASB's business combinations project that resulted in SFAS-141 and SFAS-142 (business combinations and goodwill). In particular, he looks at four Congressional events in 2000 (Senate hearings, House hearings, House bill, Senate letter) and identifies those (43) politicians who opposed the FASB position during one or more of those events. This political activity was triggered by the FASB ED position (ED 201) that would have, among other things, eliminated pooling accounting and required the recognition of goodwill, including the mandatory amortization of goodwill. He then links PAC funding of these politicians to firms and industry groups that opposed the ED. He finds the hypothesized relationships—that is, politicians who opposed the FASB position in Congress are linked to firms and industry groups that opposed the rule through PAC funding. He then goes on to look at whether firms' subsequent comment letter positions were consistent with their general opposition to the FASB proposal, and finds evidence consistent with this.

The key innovation of Ramanna's approach is that he takes a more holistic approach than most previous research, which tends to focus on comment letter lobbying. Ramanna attempts to capture a larger part of the overall political process, including for example, the various Congressional hearings and other Congressional activities, and how these activities affected the FASB's process, including the forces that caused the FASB to

issue a revised ED (ED201R) and ultimately SFAS-141/142. (It seems clear that politics did ultimately play a role: one plausible interpretation of these events is that the ultimate FASB position—to require purchase accounting and the associated recognition of goodwill but not require amortization of goodwill—was a politically-motivated compromise.³⁵)

Ramanna's paper again raises the issue of why certain firms choose to engage the political process while others do not. Ramanna finds that 186 firms lobby on the two exposure drafts (ED 201 and 201R) but that only 52 firms lobby on both. It would be useful to understand more about how firms made the decision to lobby on one or other or both of these EDs.

Presumably, participation in the political process is based on a comparison of expected costs and benefits. If firms or industries perceive their chances of success in influencing outcomes as low, perhaps they simply choose not to participate in the process.³⁶ This is relevant in the context of the business combinations project because Beresford (2001) notes that the Congressional hearings following ED 201 were dominated by firms from the high tech sector, which he found puzzling given that banks and other industrial companies were also strongly opposed to the FASB position. He posits that this occurred because of these entities' past experience on lobbying standard-setters. While the high tech firms had enjoyed some level of success (in forcing the FASB to compromise on employee stock options in the mid 1990s), the banks had not

³⁵ One can argue about exactly how this should be interpreted. Ramanna's interpretation is that the main goal of firms that aligned to oppose the original FASB position was to facilitate earnings management by making the accounting numbers more subject to manipulation by requiring what he characterizes as an "unverifiable" impairment model. Skinner (2008a) raises questions about this interpretation.

³⁶ Conversely, the evidence that large firms are more likely to be involved in the process, discussed in Section 4.1 above, suggests that these firms perceive that they are likely to have some level of success in the process.

been successful in lobbying against the FASB's position on accounting for hedging/derivatives circa 1998 and so chose not to participate in the business combinations debate (SFAS-133, "Accounting for derivative instruments and hedging activities," was largely consistent with the FASB's initial position).

This reinforces the argument made by Amershi et al. (1982) that lobbying is likely to be a multi-period game, which makes it hard to interpret what researchers observe in a single period (that is, on a single accounting issue). The decision to lobby also likely reflects a firm's or industry's current political "capital"—there is likely to be considerable time series variation in the extent to which firms and industries have power in the political process, and this is likely linked to the economic and political issues of the day. For example, in the wake of the recent financial crisis the world's large banks have been subject to a great deal of (largely unfavorable) political and media attention as well as a number of adverse political and regulatory outcomes (as one example, consider the U.K.'s decision to limit bankers' compensation).

4.4 Limitations of research on political lobbying

Perhaps the most basic and general criticism of empirical work in this area is that it is too simplistic given the likely complexity of the political process, which involves a series of complex events, beginning with those that result in a topic being added to the agenda. Further, the mapping from available theory to the empirics is sometimes relatively tenuous, in part because our theories of the politics of standard-setting are not sufficiently well-developed. This over-simplification manifests in a number of ways:

- Simple proxy variables subject to alternative interpretations; for example, the notion that size unambiguously measures political costs (Ball and Foster, 1982; Leftwich,

1990). The main problem is that our theories of lobbying are not well-developed which makes it hard to develop more specific empirical measures.³⁷ Ball and Foster (1982) also argue that early research does not adequately consider alternative theories which offer alternative explanations for extant results.

- With some exceptions, studies take a relatively narrow view of the political process, often focusing on one aspect of FASB due process such as comment letter lobbying on a single exposure draft. Further, studies tend to focus only on comment letters from public companies, and sometimes on particular types of public companies (for example, banks and insurance companies are excluded for reasons that are not obvious; samples are restricted to Compustat firms). Evidence from a number of studies shows that a large number of letters come from other types of constituents, some of which are likely to be influential (for example, industry groups such as the American Bankers Association).
- Overly-simplistic characterization of the FASB due process documents. Because researchers need to code firm responses to facilitate empirical tests, they often simplify relatively complex documents to distill one major question. How to code and characterize FASB positions becomes an even more complicated issue for studies that include multiple FASB due process documents.
- Overly-simplistic characterization of comment letter responses to FASB documents. Similar to the previous point, to facilitate empirical analysis researchers usually code firm responses in a simple way along a small number (often one) dimension. To measure the outcome of essentially the full set of FASB exposure drafts, Allen and

³⁷ Although there are certainly examples of studies that use context specific proxies and are more convincing (e.g., Mills et al., 2013; Sidhu and Whittred, 2003).

Ramanna (2013) choose to measure the extent to which each exposure draft, and responses thereto, trades off relevance against reliability. While all accounting rules are likely to do this to some degree, in many cases this will not be the most crucial accounting issue under consideration.

- Selection. Most studies look at either cross-sectional variation among firms that lobby or compare firms that lobby to some benchmark sample of firms that do not lobby. However, it is likely that firms that choose to lobby are systematically different from firms that do not. The research is hampered by a lack of theory which tells us why some firms lobby while others do not, both on single issues and on an ongoing basis (Amershi et al. 1982).

A further problem in this area is that, again for both pragmatic reasons (data collection is costly) and because of lack of precise theory, empirical researchers have to make relatively arbitrary design choices to conduct large sample analysis. For example, in the case of accounting for pensions (SFAS 87), the FASB issued a number of due process documents; researchers chose to focus on two of these rather than the full set. It is not clear whether these choices were reasonable in light of the politics that affected the process. It seems likely that more protracted standard-setting processes with more due process documents (e.g., multiple discussion memoranda or exposure drafts) are likely to be an indicator of greater political interest, yet we do not know much about what explains variation in the nature of the FASB due process such as the number and type of due process documents, public hearings, etc.

Amershi et al. (1982) make a number of points about the literature on the politics of accounting standard-setting that seem equally relevant in thinking about this research

today. Perhaps the main point these authors make is that the politics of standard-setting is a complex multi-period game that is hard to understand by looking (say) at whether firms submit comment letters or how they vote on one accounting issue. Amershi et al. argue that players in this process are likely to behave strategically and maximize what is likely to be a long-term objective function.

To make this point more concretely, the authors consider a (relatively) simple set-up with three (voting) agents and a sequence of two votes in a specified sequence. Even in this simple setting they find that:

- Agents do not necessarily vote their actual preferences, even when they have no private information.
- Agents' voting may depend on the ordering of the series of votes that takes place.
- Classifying agents into "winners" and "losers" is what they call a "delicate matter."

For example, if voters behave strategically in a sequence of votes, they may vote for a disfavored alternative to influence a subsequent set of amendments (for example, to influence the nature of a subsequent exposure draft). It may also be that voters choose their votes to influence others' views about their preferences, and thus influence others' subsequent votes. In general, the point is that it is very difficult to infer the voters' actual preferences by looking at one issue in isolation.

Amershi et al. also point out that it is hard also to look at the outcomes of (say) the FASB process and make concrete inferences about overall economic consequences, as stock price studies in accounting tend to do. As an example, they point to FAS 2 which required certain firms to account for R&D more conservatively (leading to

perceived adverse economic consequences) but note that subsequently there was a lot of politically positive sentiment for “highly favorable tax treatment for small research-oriented firms.” So perhaps the “losers” in the FASB process were actually “winners” overall.

Another example is oil and gas—although the accounting rule change proposed by the FASB (elimination of FC) was alleged to hurt small exploration firms, perhaps this subsequently led to a more favorable tax or regulatory environment, and so was in these firms’ longer-term best interests. A final example is in trucking, where there was a series of events that included deregulation of the industry, FASB action, and then proposed tax legislation. One could think of similar arguments in the context of banking and fair value—there is likely to be an interaction between economic conditions, banking regulation and accounting rulemaking that is hard to understand by looking only at one accounting rulemaking event.

5. Other empirical research on the politics of standard-setting

Large sample empirical studies on the politics of standard-setting are essentially limited to papers that examine comment-letter lobbying by companies, with a smattering of other types of studies, as described above. By focusing on such studies, one might get the impression that politics do not play a very significant role in standard-setting. However, if we consider other, more qualitative analyses of particular standard-setting episodes in conjunction with these large-sample studies, it is clear that politics can have a first-order effect on standard-setting. We discuss just a few examples.

Allen and Ramanna (2013) take a different approach to understanding standard-setting by analyzing how the individual characteristics of FASB board members and SEC

commissioners affect accounting standard-setting. This would be important under some theories of standard-setting. For example, under a regulatory capture viewpoint, the characteristics of regulators (for example, their wealth, job tenure, and employment history) may affect how likely it is that they make decisions that transfer wealth to the entities they regulate. Similarly, if one believes that regulators' have idiosyncratic ideological views, then personal characteristics such as their political persuasion are likely to affect their decisions. So it seems useful to assess the extent to which regulators' personal characteristics matter for standard-setting.

To investigate this possibility, the authors collect data on a number of the regulators' personal characteristics, including their professional background (professional accounting, financial services), tenure (length of service at the FASB or SEC), and political affiliation (measured by campaign contributions for FASB board members).

The authors then examine how these personal attributes affect the positions taken in 149 exposure drafts issued by the FASB from 1973 to 2007.³⁸ Their main tests involve regressing the "nature" of the ED on characteristics of the FASB board members and SEC commissioners. The nature of the ED is measured as how the rule affects the relevance versus reliability tradeoff in financial reporting. To measure the proposed rules' effects on the tradeoff between relevance versus reliability, the authors analyze comment letters from the Big N audit firms (they use a total of 908 comment letters from these firms).

The main tests involve (separate) regressions of the rules' effects on relevance and reliability on the characteristics of the individuals involved in standard-setting at the

³⁸ Conceptually, it is unclear why the dependent variables are exposure drafts and not final standards, which are the outcome of the standard-setting process; presumably, this is because the authors use exposure draft comment letters to measure the nature of the accounting rule.

time. The strongest finding is that FASB board members with a financial services background are more likely to support rules that decrease reliability and increase relevance; other variables are generally not significant.

While the broad motivation—to better understand the role of individual incentives in standard-setting—is appealing, the authors have difficulty in clearly specifying these incentives and how they are likely to affect standard-setting. In part, this is because accounting standard-setters are likely to be somewhat different from other types of regulators in that they are not politically appointed, as discussed in Section 2. Further, it seems unlikely that the relevance versus reliability tradeoff is consistently at the heart of the discussion—other more specific issues are likely to be more important. Thus, while a strength of the paper is that—in contrast to much prior work—it focuses on a large number of accounting issues, this means the authors have to come up with a measure that is common to a large number of accounting issues addressed by standard-setters, which is inherently difficult.

In general, it also seems useful to ask about the role and influence of individual standard-setters in the production of accounting standards. This is potentially important because of the relatively small size of the boards (the FASB has seven board members) and the long times that individuals can serve (terms are five years, and individuals can serve two terms).³⁹ If individual board members tend to have strong “world views” that influence how they (and their colleagues) think about capital markets and the role of

³⁹ To take one example, James Leisenring served as research director of the FASB from 1982-1987, on the board itself from 1987 until 2000 (including from 1988 onwards as vice chairman), as the board’s first director of international activities in 2000, and then on the IASB from 2001 to 2010, as well as being chair of the G4+1 (an influential international group of standard-setters) through 2001.

financial reporting, individual beliefs could have an important effect on standard-setting (this is essentially the Ideology model of regulation, discussed earlier).

Bischof et al. (2013) design a large sample empirical study around a key change in accounting standards that occurred during the recent financial crisis. They describe how in October 2008, under intense pressure from the EU and without its normal due process, the IASB amended IAS 39 to allow entities to retroactively reclassify financial instruments in such a way as to avoid reporting fair value losses. According to Andre et al. (2009), the IASB was forced to take this action to avoid imminent action by the EU, which was preparing legislation that would have carved out the relevant portion of IAS 39, something the IASB viewed as potentially damaging to its credibility as the standard-setter responsible for global accounting standards. Examples such as this make it clear that political considerations can have first order effects on standard-setting.⁴⁰

Perhaps the best known recent example of political interference in standard-setting was the tremendous political pressure that industry, and particular high tech firms that used ESOs extensively, put on the FASB in the mid-1990s. Initially, in its exposure draft, the FASB proposed requiring firms to expense the estimated fair value of ESOs issued to employees, an idea that would have reduced the reported earnings of firms that used options as compensation, in some cases substantially. This pressure came in the form of a series of bills that were introduced in Congress to pressure the FASB (Zeff, 2002). According to Beresford (2001), both houses of Congress initiated legislation that would have exempted companies from any FASB rule that required them to expense the fair value of ESOs. In addition, that legislation required the SEC to initiate its own rule-making process for all future accounting standard-setting, a provision that would have

⁴⁰ See Skinner (2008b) for another example.

effectively ended the FASB. Beresford (the FASB chairman during this period) indicates that the majority of the board perceived the probability of that legislation succeeding as high, which led to the compromise that resulted in SFAS-123.

These examples make it clear that politics can play an important role in standard-setting. The challenge for researchers is to provide larger sample evidence of the extent to which this is generally true—are situations such as we observed in Europe in 2008 with IAS-39 or in the US with ESOs in the mid-1990s extreme versions of a general problem, or is it the case that politics only matters for standard-setting on rare occasions? In spite of several decades of research, it is still not clear how to answer this question.

6. Conclusions and Suggestions for Future Research

We summarize extant empirical research on the extent to which political forces shape accounting standards in the U.S. In spite of the fact that we have nearly four decades of research on this topic, progress has been relatively modest and there has been relatively little research in the past decade. As one example, it is still not clear how well extant economic theories of regulation characterize accounting standard-setting or how accounting standard-setting differs from other forms of regulation. This provides a number of opportunities.

First, we have little formal evidence on the factors that affect how accounting standard-setters set their agendas. While anecdotal evidence suggests that political forces can in some instances directly affect the agenda, as was the case with oil and gas accounting in the 1970s, it is unclear how important political forces are more generally in agenda setting. This is a crucial question because agenda decisions determine which topics are considered and which are not, and so is arguably *the* most important decision

made by standard-setters in terms of determining the accounting rules that come into force.

Second, in spite of a relatively large volume of research on comment-letter lobbying in the standard-setting process, what we know is limited. Most of this research analyzes comment letters submitted by preparers (companies and managers). There is clear evidence that large firms are more likely to submit comment letters although interpretation of this result is less clear. It also seems important to understand whether lobbying by firms and industries depends on whether they are in or out of political favor at a given point in time, as well as other factors that influence time-series and cross-sectional variation in political engagement.

We have evidence that firms' lobbying activities depend on the likely effect of the proposed rule on their financial statements (e.g., large adverse financial statement effects, especially declines in reported net assets and/or income increase the likelihood of lobbying) as well as other evidence broadly consistent with economic consequences arguments such as correlations between lobbying and the use of bonus plans and leverage.

Third, although there are clearly situations in which politics affects accounting standard-setting outcomes, as with ESOs in the 1990s, we do not have a great deal of systematic evidence on the role that politics play on standard-setting beyond comment letters, although some recent research has begun to change that (e.g., Ramanna, 2008).

Our review leads us to offer a number of suggestions for how future research can improve our understanding of the role of politics on standard-setting, a topic clearly of

significant import to everyone with an interest in financial reporting. Some possibilities include:

- Research on how a broad set of constituents, including preparers, the Big 4, other accounting firms, industry groups and other entities participate in the political process. In addition to lobbying through comment letters, what tools do these entities use to influence accounting rules? Do these entities engage in the process occasionally, when a particular accounting rule is likely to affect them, or are they involved in the process consistently over time, in which case we need to consider their engagement as a multi-period game? What role do industry associations and other similar groups play?⁴¹ What types of entities repeatedly engage in the process and why? How does engagement in the standard-setting process relate to firms' overall levels of engagement in the political process more generally (for example, is it related to lobbying for changes in the tax code, on other forms of regulation)?
- Can we develop a richer understanding of the underlying characteristics of accounting issues that generate the most political "heat" for standard-setters? Are they issues that involve additional disclosures, issues that significantly change recognition practices (as with ESOs, pensions, other post-employment benefits), issues that eliminate existing choices (as with business combinations, oil and gas), or is there some other key attribute of accounting issues that drives political attention?

⁴¹ Zeff (2002) argues that industry groups such as Financial Executives International (FEI) and The Business Roundtable have "forcefully" (p. 44) presented industry's views to standard-setters on a variety of topics over a long period of time and at times used their influence to involve Congress in the process.

- Can researchers do a better job of characterizing constituent responses to proposed FASB rules? There is a great deal of richness in these responses, as well as in FASB due process documentation generally, that researchers can better exploit to more fully understand the process. Now that we have machines that are able to analyze and process text in sophisticated ways, the costs of analyzing these data are falling quickly, which seems likely to provide research opportunities.

While early research tackled some of these questions, much of that research took place relatively early in the FASB's lifespan. We now have a much longer time-series of data on the FASB, which facilitates more powerful and systematic analysis. Further, the FASB has a large database of due process documents and responses to those documents, which provides a rich source of largely unexplored data we can use to address these questions.

These ideas are merely a starting point; there are likely to be others as well. But they do, we hope, illustrate that this research has a great deal of potential, especially given its importance in policy circles as accounting has become an increasing focus of political and regulatory attention in the wake of the financial crisis.

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Table 1: Summary of Selected Empirical Papers on Lobbying on Accounting Standards by Preparer Firms and their Managers.

Authors (year): journal	Topic (standard) and type of document	Sample size	Main dependent variable	Theory	Key results
Watts and Zimmerman (1978): TAR	Firm comment letters on price level from 1974 DM	53	Firm “vote”: supportive (or not) of price level adjustments in financial statements	Managers trade off several conflicting incentives. On balance, for income increases caused by price level accounting, the net benefit is <i>decreasing</i> in firm size. For income decreases, the net benefit is <i>increasing</i> in firm size.	For firms that are expected to have income decreases, supportive position appears to be <i>declining</i> , opposite of theory. Expected increases appear to uniformly oppose price level accounting.
Brown (1981): JAR	Firm responses to policy questions across several areas from 8 DM and 1 ED	51 questions answered by 27 respondents	Respondent proximity to ex post FASB revealed preference: SFAS position	Respondents within obvious grouping categories (sponsoring organizations, accounting firms, business preparers, etc.) will have proximate preferences.	FASB preferences are not clearly related to any specific category of respondent. An “eye ball” result is that Financial Analysts Federation (the only user respondent) has fairly proximate preferences to the FASB.
Kelly (1982): JAAP	Firm comment letters on foreign currency from 1975 ED	52: 14 lobby, 38 non-lobby	Firm lobby choice. (Non) Lobby group obtained from PMM & Co 1977 survey.	Firms that lobby the FASB will ex post change financing and operating activities if the standard is enacted.	Firms that lobby were <i>not</i> more likely to ex post change financing or operating activities.
Kelly (1985): JAR	Firm comment letters on foreign currency from 1975 ED	170: 54 lobby, 116 non-lobby	Firm lobby choice. (Non) Lobby group obtained from AICPA 76 & 77 publications	Management incentive contracts and ownership, debt contracting, size (proxy for political visibility), and foreign activity impact lobby choice. Likelihood to lobby <i>increasing</i> in these firm characteristics.	Lobbying firms were found to be larger, have greater percentage of foreign sales (non-surprising result) and lower management ownership.
King and O’Keefe (1986): TAR	Firm comment letters on oil & gas cost from 1978 ED	83: 34 lobby, 49 non-lobby	Insider trading activity	Management has a diverse set of beliefs concerning the impact of cost treatment on firm outcomes and will respond to	Weak evidence that managers of full cost firms which engaged in lobbying sold more stock following the release

Francis (1987): JAPP	Firm comment letters on pension from 1982 PV	800: 218 lobby, 582 non-lobby	Firm lobby <i>against</i> .	Firms that lobby will likely be larger, have significant increases to leverage by recognizing a net pension liability, volatility in pension expense. These changes will adversely affect firms' contracting outcomes.	Univariate difference in means and multivariate logistic regressions generally support the hypotheses. Results are less robust in subsequent matched tests.
Deakin (1989): TAR	Firm comment letters on oil & gas cost from 1976 DM, 1978 ED, 1978 SEC appeal	DM: 94 ED: 118 SEC: 118	Firm lobby choice. (Non) Lobby group obtained from FASB list of "full cost" firms.	Managers trade off several conflicting incentives. Likelihood to lobby <i>increasing</i> in some firm characteristics.	In logistic regressions: Debt index variable, compensation contract and regulatory indicators, and investment levels load positively across these response opportunities.
Ndubizu, Choi, and Jain (1993): JAAF	Firm comment letters on pension from 1985 ED	1,819: 173 lobby, 1,646 non-lobby	Firm lobby <i>against</i> . I/S lobbyists (n=133), B/S lobbyists (n=115)	Theory largely consistent with Francis (1987).	Findings largely consistent with Francis (1987).
Saemann (1995): JAAF	Firm comment letters (subsample) on pension from 1981 DM, 1982 PV, 1983 DM, and 1985 ED	81DM: 27 PV: 53 83DM: 30 ED: 49	Firm specific position on issues within FASB documents	A process to build consensus will result in firms yielding to FASB preferences on select issues and FASB yielding to firm preferences on select issues.	Difference in means suggests that FASB responded to firm consensus on some implementation issues (e.g. salary adjustments in liability measurement). Other issues like comparability were areas where firms yielded to FASB preferences.
Dechow, Hutton, and Sloan (1996): JAR	Firm comment letters on share-based compensation recognition from 1993 ED	347 against, varying size control groups	Firm lobby <i>against</i> . Control group(s) matched on size in 3-digit SIC.	Agency and political costs cause managers to lobby against recognition of SBC. Internal capital financing constraints cause firms to be more likely to utilize SBC and suffer external financing shortfalls when required to expense, so lobby against the ED. Firms with tight debt covenants lobby against recognition of SBC.	Univariate difference in means and multivariate logistic regressions support agency and political cost arguments of high proportion of SBC lobbying. Evidence on other hypotheses inconclusive.
Hill, Shelton, and Stevens (2002):	Firm comment letters on share-based	262	Firm lobby for proxy disclosure vs. annual report	Agency, political, or proprietary costs cause managers to lobby against disclosure or recognition of SBC in	Univariate difference in means and multivariate logistic regressions are consistent with hypotheses.

ABACUS	compensation recognition from 1993 ED		disclosure. (148 vs 80) Firm lobby for summary vs. pro forma (actual) net income (80 vs 24(8))	annual report. Also, those with higher levels of SBC will prefer summary measures instead of pro forma income calculations.	
Johnston and Jones (2006): JAPP	Firm lobbying expenditures during various SEC and FASB projects related to earnings management, business combinations and transparency of liabilities during 1999 to 2000	4,090 total: 590 lobby, 3,500 non-lobby	Firm lobbying expenditures Lobbying expenditures greater than 0 (dichotomous variable)	Exposure to changes in accounting for business combinations and revenue recognition more likely to lobby regarding changes in these standards. Impact of above incentives is greater for 'Occasional lobbyists' (those without in-house PR) than 'Habitual Lobbyists' (those with in-house PR)	Probit regressions and OLS regressions using Heckman two-stage procedure to correct for self-selection bias demonstrate that firms with greater exposure to changes in accounting standards are more likely to lobby, and to a greater extent. Occasional lobbyists drive this result, indicating greater impact for these firms.
Ramanna (2008): JAE	Congressperson position on pooling method in identified congressional actions Firm comment letters on the same from 1999 ED and 2001 ED	498 ED99: 104 ED01: 134	Congressperson position. Firm lobby <i>against</i> Firm lobby for low verifiable goodwill subsequent measurement.	Managers of acquisitive firms lobby for pooling treatment to obtain highly desirable financial statement outcomes (higher earnings, smaller balance sheet). These same firms will prefer purchase treatments that have lower verifiability of goodwill and avoids amortization.	Univariate and multivariate probit regressions (simultaneously determined with levels of congressional contributions) demonstrate an association between firm donations and congressperson support of pooling treatment. Further tests demonstrate an association between firm being pro-pooling and preferring no amortization and low verifiability of goodwill.
Mills, Nutter, and Schwab (2013): TAR	Political Outcomes: differences in Federal Effective Tax Rate	1,970 for 'No Compete' and 'Defense' measures of bargaining	Federal Effective Tax Rate	Firms with high political sensitivity incur higher political costs. Higher bargaining power of the firm mitigates these political costs.	OLS regressions with industry fixed-effects consistent with predictions. Mixed evidence for predictions regarding controls.

		<p>power, 723 for 'Concentration' measure</p> <p>250 observations for tests including control for lobbying activity</p>		<p>Secondary predictions made for a variety of control variables.</p> <p>[Indirectly related to standard setting through focus on 'political cost' hypothesis']</p>	
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