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Due Process in Financial Accounting

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Abstract

This study intended to descriptively elaborate on the due process of standard-setting in Financial Accounting. A literature review was conducted to explain the due process concept. This study discussed the importance of developing or creating standards in Financial Accounting, the standard-setting in various countries, and the uses of due process in developing the standards. As a result, it was found that the standard-setting process is affected heavily by political factors. Standard setters, Financial Accounting Standard Board, and International Accounting Standard Board cannot avoid political factors in developing or creating the standards. Consequently, due process is used to formulate the standards to facilitate the political factors in setting the accounting standards.

Keywords: Due Process, Financial Accounting Standards, Political, Literature Review, Process Concept.

1. Introduction

There are two institutions that deal with the development financial accounting standards. The two most known bodies are the Financial Accounting Standard Board (FASB) and the International Accounting Standard Committee (IASC), which has evolved into the International Accounting Standard Board (IASB) [1]. Moreover, there must be a commitment to restructure the financial sector by getting standard-making bodies to cooperate in formulating standards. Standard development is done to create global quality standards [2]. The functions of these two institutions are basically the same, which is to provide standards that can increase the quality of reporting [3]. Furthermore, the Accounting regulations should also be developed along with changes in the economic environment and the use of accounting information [4].

The development of accounting regulations depends largely on the decision-making bodies. Therefore, the decision-making process becomes crucial. The decision-making body formulates the decision by asking for views from the parties related to the decision to be made. These parties are among others all interested in financial accounting and financial reporting. In summary, these parties are creditors and investors (users of financial statements), providers of financial statements, and auditors of financial statements. This process of asking for views is called the Due Process [5]. The due process is a concept that reflects a concern for the stakeholder in regulation making. This process refers to the procedures and stages of protection that relate to decision making. In law, due process can be interpreted as testing when the state is acting on whether the rights of an individual are respected. For this reason, the implementation of the due process is expected to create the optimum standards for all the stakeholders [6].

This article discusses some specific topics regarding the Due Process. First, this article discusses the importance of developing standards in financial accounting. Second, there are several reasons for the emergence of the due process in the formulation of financial accounting standards. Then, this article discusses the nature of politics in the standard preparation process that affects the process. The final section will discuss due process steps by FASB and IASB.

Corporate transparency and disclosure development are needed in the current era of globalization. To achieve this, the effective implementation of standards should be done. These standards must be adjusted along with the changing business environment. Many countries known as Anglo-Americans have contributed to the development of the standard. The development of this standard is very inseparable from the role of politics [7; 8]. The development of financial accounting standards is needed to improve the quality of financial reporting, especially with several accounting scandals such as the Enron case in 2001 [1].

A study was done to examined the implementation of standards in China. They found that along with trends from international capital markets, users of accounting information are asking for information that better reflects the level of objectivity, accuracy, comparability, and transparency. In short they need more quality information in reporting. To meet this demand, of course, standards needs to be developed to adjust with the need. They tested the impact of the new accounting standards on business enterprises. One of the standards tested is the implementation of fair value to companies. They found that the new

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standard implemented increased the company's profits even though implementing fair value was difficult. This study concluded that implementing new standards or developing standards can affect the quality of the information presented in the financial report [9]. From a different point of view, another study found that adopting IFRS standards did not increase the quality of financial reporting. This is due to the lack of investor protection, inefficiency of the judiciary, and weak implementation mechanisms [10]. There are several countries who have successfully implemented the convergence of IFRS. One of the keys to the success of IFRS implementation is continuous development. The success of a rule-making body is that it must make developments on the standards they have created [11; 12].

There are several things that can be done to raise the standard quality. The demand for the development of the standard leads to the participation of many organizations to assist in developing financial accounting standards. This development is considered to be achieved with the cooperation of other organizations. For example, many organizations have helped the development of the American Accounting Association, such as the Financial Executive Institute, the Financial Analysts Federation, the Robert Morris Associates, and the National Association of Accountants. With the help of these parties, the rule-making body at that time, namely the Accounting Principles Board (1959-1972) received a lot of input such as opinions, criticisms, and suggestions from those institutions. One of the important topics raised is also the need for accounting research [13]. Financial accounting research can be defined as measuring and communicating financial information. Modern accounting research owes much to research that was originally conducted in the 1960s. The research about Accounting may help the standard maker to develop the standard. Therefore, a new standard or an enhancement of the current standard can be made [14].

Globalization has resulted in adopting standards created by the FASB and the IASB by countries worldwide. The accounting profession in the organization plays an important role in implementing standards in the local country. One of the biggest challenges rule-making bodies faces is how the standards can be adapted to the countries that adopt those standards. Accounting objectives, accounting standards, and accounting techniques are resulted from environmental factors within each country. One of the best examples of environmental factors is the political factors influencing accounting standards [15].

In summary, countries with different local contexts will look at accounting standards with different views [16]. This different views has resulted in local variations in viewing and applying Accounting standards [13]. A study was conducted to give an example of the implementation of accounting standards in Iran. This country has adopted international Accounting standards, however, there are some differences between accounting standards in Iran and international accounting standards, and also, there are some standards that cannot be implemented in the country [17].

2. Discussion

After a group study process, the American Institute of Accountants (AICPA) recommended the establishment of the FASB. The formation cannot be separated from the influence of industry, financial analysts, accountant educators, and the accounting profession. The SEC assigns the task to the FASB to conduct research in developing institutional frameworks that come from various points of view. In summary, the FASB carried out the task must look at the principle from various points of view because many parties must be involved in drafting the framework. This indicates that the previous decision-making bodies namely CAP and APB carried out their duties in a narrow point of view, which brought a lot of criticism from the industry, analysts finance, accountant educators, and the accountant profession that eventually led to the establishment of the FASB [18]. As long as financial accounting standards can influence the company's future cash flow, the standards-making body will face political pressure with corporate lobbying [19].

The main failure of the profession is to shut down interventions in standard-making. The standard creation process did not use the due process concept. This lack of due process has resulted in standards published by CAP and APB being slightly accepted among standard users. FASB works more successfully than previous bodies because due process has been implemented. Although the process of compiling standards with due process takes a long time, it is generally acceptable to users. They added that this long process is a matter of course because it reflects the very nature of democratic politics. CAP and APB have carried out their duties well but due to the lack of use of due process involving parties related to the standard, their publication cannot be accepted broadly in general. Furthermore, with due process in preparing financial accounting standards, the political process becomes inseparable from preparing this standard [20].

Furthermore, politics cannot be separated from social. Politics can also mean the process of developing consensus or mutual agreement. In this case, achieving the agreement requires socialization. Evolving from the previous definition, they added that politics is the result or consequence of social action. One form of social action is decision-making for the establishment of accounting standards. So, the decision-making process of setting accounting standards cannot be separated from the political nature [21]. In preparing financial accounting standards, the process cannot be separated from interference from parties related to these standards. The main tiers in the preparation of standards can be seen on Figure 1 [22;23].

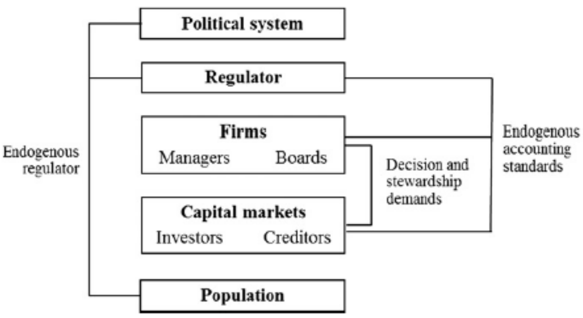

Figure 1. The Main Tiers In The Preparation of Standards

The Figure 1 describes about the main layers in accounting regulation. The constituents of the standard may consist of different institutions. The standard drafting process is a political system that involves many parties [22].

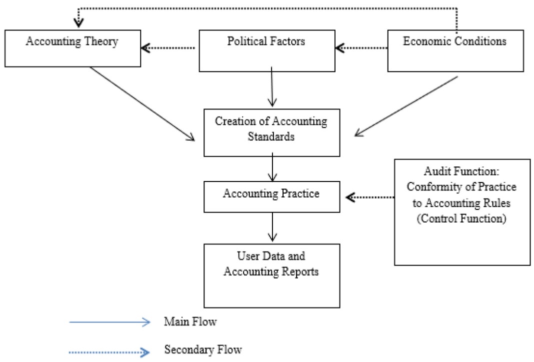

Figure 2: Financial Accounting Environment

Figure 2 explains that financial accounting standards are formed through accounting theory, economic conditions, and political factors. The main flow describes the process of formulating financial accounting standards. The secondary stream shows how economic conditions and political factors influence accounting theory. In practice, the control function is carried out by an audit to check whether the practice follows the standards. Financial accounting cannot run in the absence of political factors. For example, FASB and IASB who become the institutions to establish the standards for accounting will be heavily affected by political environment [20].

A study was done to examine the political process by which companies have a role in lobbying for financial accounting standards. He researched institutional settings in Europe and America. America has had a longstanding custom of making financial accounting rules in the private sector while European countries give this role to the legislature. Europe and America have used due process in formulating financial accounting rules. The research results show that for European countries, companies usually directly lobby the IASB if standards do not match their expectations. Political lobbying is more prevalent in Europe than in America [24]. To conclude, the drafting process in financial accounting standards is affected by political process [25].

After several cases of fraud that harm information users in America, such as Enron and Worldcom, large companies have focused on the standards setters and how information generated from standards is provided to general users. Through this case, a new rule called the Sarbanes-Oxley Act was born which states that the standards issued must increase the accuracy and reliability of financial statements. Furthermore, in drafting standards, managers can influence financial accounting standards in two methods: direct and indirect. Directly, managers can lobby the SEC by writing comment letters regarding the standards. Indirectly, institutions might lobby congress to hear their opinion regarding the standards. Managers can do just that with congressional hearings, where managers can present their opinions on standards that can be economically bad [26].

Standard-makers set standards in terms of efficiency and reduce conflicts between principals and agents (Agency Theory). They see a political factor in the spread of Fair Value standards. The biggest change by IFRS in the accounting world is to bring the concept of fair value. In introducing this method, the standard-making body encountered political problems from the Anglo-Saxons with strong political power. The solution obtained by IFRS is also not entirely technical because they need to deal with political problems. This concept encountered many problems, and they encouraged the researchers to research further, especially on the political consequences that would be faced [27].

A study was conductd to give a perspective on preparing financial accounting standards from Australia. Two factors are the main issues in accounting. First, the bankruptcy of companies, Second, the development of government intervention in financial accounting regulation. In the 1940s to 1970s, accounting bodies in Australia merged their powers to form the Australian Accounting Standard Committee and the Australian Accounting Research Foundation. In 1980 the government began to act by creating the Accounting Standards Review Board and the Public Sector Accounting Standards Board. In the 1990s much criticism came to the profession for developing the framework adopted from the American framework. Since 2000, professions have shifted their standards to internationally issued by the IASB [28].

There several steps that become procedures in developing a due process [29]. The following steps are:

"Firstly, The Board identifies financial reporting issues based on requests/recommendations from stakeholders or through other means. Next, The FASB decides whether to add a project to the technical agenda based on a staff-prepared analysis of the issues. Third, the Board deliberates at one or more public meetings the various reporting issues identified and analyzed by the staff. Then, the Board issues an Exposure Draft to solicit broad stakeholder input. (In some projects, the Board may issue a Discussion Paper to obtain input in the early stages of a project.) Fifthly, the Board holds a public roundtable meeting on the Exposure Draft, if necessary. Next, the staff analyzes comment letters, public roundtable discussion, and all other information obtained through due process activities. The Board redeliberates the proposed provisions, carefully considering the stakeholder input received, at one or more public meetings. Lastly, the Board issues an Accounting Standards Update describing amendments to the Accounting Standards Codification (para. 4)".

To conclude, the financial accounting standards-making bodies (FASB and IASB) cannot be separated from political factors [30]. Moreover, capture theory explained that standard-makers would need to consider the need of the industries in which the standard would affect [31; 32].

3. Conclusion

Accounting standards need to be developed to adjust to the development of the business. The development is intended to increase financial reports' quality, reliability, and accuracy. The standard-setter institutions formulate these standards. However, there were times when these standard-setters experienced failure. The narrowness caused the failure of some accounting standard-setter institutions in developing the standards. A broad point of view needs to be considered in setting the standards. One of the factors that heavily influenced the standard-making process is the political factors. This factor cannot be avoided or separated in setting accounting standards. Across some countries, this factor is proven to affect the standard development process. Both famous accounting standard-maker bodies, Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), have learned to include political factors in setting their respective standards. They both use due process in setting the standards. This process requires the standard setters to consider every possible aspect influencing standard development, including political factors. Therefore, the standards created that follow due process are not only intended to increase the quality, reliability, and accuracy of financial reports, but it is also expected to meet the needs of related parties.

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