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Article abstract

This study examines constituent participation in the accounting standards setting process in Canada to determine whether the positions of auditors and their clients relative to new accounting standards proposals are independent of each other. Using responses to the ten accounting exposure drafts receiving the highest public responses, the active role of Big Eight (now Big Five) firms is underscored. For all responses, significant agreement between Big Eight/Five auditors and their clients in their respective positions on proposed new accounting standards is found. However, domination of the process by Big Eight/Five firms through indirect influence of their clients' responses to individual exposure drafts is not supported. Disagreements among Big Eight/Five firms and between Big Eight/Five firms and their clients are found. Overall test results indicate that relative to the core issues on which new accounting standards are needed, auditors and their clients generally respond independently, even if there were some new proposals on which they had the same views. The findings suggest that independent corporate and audit-firm motivations explain the decision to participate in the accounting standards setting process. The real motivations for the active participation in the process by auditors and corporations are subjects for continued research.

Auditor-Client Dependence in the Development of New Accounting Standards in Canada

by

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ABSTRACT

This study examines constituent participation in the accounting standards setting process in Canada to determine whether the positions of auditors and their clients relative to new accounting standards proposals are independent of each other. Using responses to the ten accounting exposure drafts receiving the highest public responses, the active role of Big Eight (now Big Five) firms is underscored. For all responses, significant agreement between Big Eight/Five auditors and their clients in their respective positions on proposed new accounting standards is found. However, domination of the process by Big Eight/Five firms through indirect influence of their clients' responses to individual exposure drafts is not supported. Disagreements among Big Eight /Five firms and between Big Eight/Five firms and their clients are found. Overall test results indicate that relative to the core issues on which new accounting standards are needed, auditors and their clients generally respond independently, even if there were some new proposals on which they had the same views. The findings suggest that independent corporate and audit-firm motivations explain the decision to participate in the accounting standards setting process. The real motivations for the active participation in the process by auditors and corporations are subjects for continued research.

INTRODUCTION

Since the 1970s, the then Big Eight (now Big Five) accounting firms have been perceived to dominate the accounting standards setting processes in the US, Canada and elsewhere through their size, dominance of other accounting firms, and big share of the large corporate clients market. Although the Canadian Institute of Chartered Accountants (CICA) has the sole authority to issue accounting and auditing standards in Canada, it still uses a due process for standard setting, much like that of the Financial Accounting Standards Board (FASB), which is not the final authority on accounting standards in the United States of America. During the 1970s the CICA was mailing out about 40,000 copies of each new exposure draft to its members and subscribers of its *Handbook* for comments. However, from 1981, distribution was cut by 80% to only about 6,800 people per exposure draft. The reduced distribution was due to the poor response rates to the earlier exposure drafts. It was also not until the 1980s that the CICA started compiling booklet forms of the exposure draft and its related responses into what it calls the *Public Record*. The first public record issued was in 1984 for the 1983 exposure draft on Investment Tax Credit. By 1996, 52 public records had been issued. Since then, exposure drafts have received wider circulation through publication in the CA Magazine and on the internet.

Against this backdrop, this study examines participation in the Canadian accounting standards setting process to determine whether auditors influence their clients' responses and positions relative to new accounting standards proposals. It highlights the role of relevant parties which, given the limited distribution environment prior to 1996, were interested in the outcome of potential accounting standards enough to participate in the process. Efforts to increase participation can be directed at areas with minimal participation. Furthermore, an understanding of the various constituents will permit studies on their participation motivations. If the process is being patronized by a limited dominant group, then further examination of their real influences can be examined. Finally, the study extends examination of constituent participation in accounting standards setting in the accounting literature into the Canadian context.

BACKGROUND AND PRIOR RESEARCH

The CICA's involvement in developing accounting principles began in 1946, when it issued its first recommendation in the form of a bulletin. Several bulletins followed until all bulletins were reorganized into the *CICA Handbook* in 1968 (Baylin et al, 1996). The formalization of the role of the CICA as the standard setter of accounting for the wider business community began in 1972 when the Canadian Securities Commission made compliance with the *CICA Handbook* recommendations a requirement for all publicly trading firms (Murphy, 1980). The federal government gave its support to the *Handbook* in

1975 when the Canada Business Corporations Act required the financial statements filings by firms incorporated under the Act to be in accordance with the *CICA Handbook* (Baylin et al, 1996). Soon afterwards several provincial governments passed similar compliance laws for firms incorporated under provincial jurisdiction. These actions “essentially granted the CICA a monopoly for accounting standards setting in Canada” (Falk, 1988, 29).

The CICA’s due process in accounting standards setting involves: (1) review of research proposals, (2) project proposal, (3) statement of principles, (4) exposure draft, (5) significant changes (re-exposure draft), and (6) CICA handbook recommendations or shelving of project. Constituent participation occurs during the exposure draft stage. Tandy and Wilburn (1992) see the due process or participation in the standard setting process as necessary to ensure the legitimacy of the standards setting authority. Since acceptance of the standards depends partly on the perceived legitimacy of the standard setting authority, due process procedures help to create the perception of legitimacy, help prevent standards that are unworkable, overly costly, or even inconsistent with basic concepts, and provide a formal systematic approach to problem solving and standards setting. In the Canadian context, due process may be necessary not only to preserve the integrity of the process but also to ward off possible government intervention.

Prior research has identified the motivations for lobbying on accounting standards to include (a) the advantage to be gained from a favourable outcome (resulting standard is the preferred outcome desired by the lobbyist), and (b) the preservation of private control of the standard-setting process (Tandy and Wilburn, 1992; Sutton, 1984). The only research work on the influence of large accounting firms on the standard setting process in the United States by Puro (1985), found no support for large firm domination of the process although they participated more often. There have also been several studies providing descriptive information on constituent participation in standards setting in the US, Australia, and the UK, but no such studies exist in the Canadian context. For example, Nakayama et al. (1981) noted the low level of responses from all respondent groups, notably, public accounting, academicians and financial analysts to the FASB’s exposure draft on leases, while Mezas and Chung (1989) found for 30 randomly selected FASB exposure drafts that financial statement preparers wrote more letters than all other groups combined. This study introduces a Canadian perspective to the literature on constituent participation in the accounting setting process.

The work of Gravens et al. (1989) on Australian companies provides additional insights into the decision to participate. They found that larger companies participate to a greater extent than smaller companies in the Australian standard setting process. They posited that this could be due to participation costs being relatively smaller for larger firm and the tendency of larger firms to have formal procedures for participation.

Other studies have investigated the decision to participate in the standard setting process in the context of the economic consequences of accounting choices. Thus, the decision to lobby is investigated through the relationship between firm characteristics and their disposition towards accounting choice through the use of standard political and economic consequences hypotheses advanced in the positive accounting literature (e.g. Watts and Zimmerman 1990, Holthausen 1990 and Morhrman 1993) as potential explanators of many types of accounting choices. This approach was used by Arcelus and Trenholm (1991) and Abekah et al. (1999) in the Canadian context. There is some evidence in these studies of a relationship between the decision to lobby and economic incentive variables.

While a number of studies, especially the economic consequences studies, focus on one constituent group, this study follows Tandy and Wilburn (1992) in first examining the participation of all constituent groups, and then Puro (1985) by examining the presence, if any, of auditor-client dependence in the standards setting process in Canada.

DATA

The CICA's public records form the data sources for the analysis in this study. *All* public records that were available at the end of 1996 relating to financial accounting standards were examined. The public record includes the exposure draft, the written comments received, and the final recommendation, if any. By 1996, fifty two public records had been prepared. Unlike the FASB, the CICA does not provide a breakdown of responses by constituent groups. Each response letter, therefore, had to be reviewed to determine its appropriate constituency. Of the 3487 responses to the 52 exposure drafts covered in the public records, 39 were anonymous, leaving usable responses of 3448. Twenty-one of the fifty-two exposure drafts were accounting recommendations, twenty-one dealt with auditing recommendations, and ten dealt with government and non-profit issues. There were 1922 responses (23 of them anonymous) related to the accounting recommendations, 1039 responses (8 anonymous) related to auditing, and 526 responses (8 anonymous) to the government and non-profit exposure drafts. For the purpose of examining the role of large accounting firms and their clients in the process, the ten accounting exposure drafts receiving the highest responses were used. The definition of constituencies by the FASB as "all who have an interest in financial accounting and reporting" is used in this study. Constituencies, identified from reviewing the response letters in the fifty two Public Records are: (1) Accountants and Accounting Firms, (2) Provincial Accounting Bodies, (3) Government and Security Regulators, (4) Public Corporations, (5) Crown Corporations, (6) Other Professional Organizations, (7) Academicians (8) Other Individuals, and (9) Banks.

RESULTS AND ANALYSIS

Table 1a presents information about total participation relative to the fifty-two exposure drafts. The most active constituencies were accountants and accounting firms (34%) and public corporations (26%). Significant participation is also observed for government and security regulators (14%), provincial accounting bodies (10%), and other individuals (6%). When provincial accounting bodies are combined with accountants and accounting firms, 44% of all responses came from those directly involved in the accounting profession. The category of exposure draft affects participation. Accountants and accounting firms were very active constituents in all three (accounting, auditing, not-for-profit) exposure drafts categories. Since this group includes auditors, this result is to be expected. Accountants should naturally be interested in accounting, auditing and even government/non-profit accounting recommendations. On the other hand, public corporations were the most active constituents on exposure drafts dealing with new accounting reporting standards. They were not very active on auditing recommendations and were least active on government/non-profit related recommendations. This was also as expected as business companies would be more interested in changes to accounting standards for their financial reporting purposes than in auditing standards or government/non-profit standards.

Responses to Individual Exposure Drafts

In the accounting recommendations category, 44% of the overall responses were from public corporations and 27% were from accountants and accounting firms. Responses to individual exposure drafts show that the subject matter of the exposure draft affects the level of participation by all groups. For example, the responses to the exposure draft on Financial Statement Concepts had 50% of the responses from accountants and accounting firms, while only 5.6% were from public corporations. Conversely, for the exposure draft on Corporate Income Taxes, 60% of the responses were from public corporations and 24% were from accountants and accounting firms. Obviously, corporations are more interested in taxes than the theoretical ideals of financial statement concepts. Furthermore, the corporate income taxes exposure draft attracted the highest overall response of any of the drafts studied, at 274, while the financial statements concepts draft attracted the lowest responses in the accounting category. It is also noteworthy that in the accounting and auditing categories, accountants and their related firms and bodies account for 70% or more of the participation in the standard setting process. This is similar to Tandy and Wilburn (1992) study for the U.S.A. where they found a 72% concentration for accountants and their related firms.

Auditor-client Dependence in the Standards Setting Process

For this part of the study, the ten exposure drafts relating to accounting standards that attracted the most responses were used. These were the drafts on (1) investment tax credit, (2) statement of changes in financial position (cash flows), (3) pensions, (4) revenue recognition, (5) portfolio investments, (6) income taxes, (7) future oriented financial statements, (8) pensions (reissued), (9) property plant and equipment, and (10) capital assets (reissued). Auditor-client dependence was analyzed by examining the extent of agreement or disagreement between auditor and client positions on the overall standards, and on individual standards. If a firm responded to the exposure draft, its auditor also had to have responded for it to be used in the analysis. Only clients of Big Eight/Big Five auditing firms were used for this analysis because only those Big Eight/Big Five firms responded frequently enough to have enough samples for the analysis. Response positions on the core issue(s) of the new standards being proposed were categorized as yes or no. These responses were then used in contingency tables for Chi-Square tests of independence to be performed. The results are reported in Table 2.

The results indicate that for the ten exposure drafts studied as a whole, client and auditor responses were not independent of each other. There was significant agreement between the responses of auditors and their clients. On individual exposure draft basis, however, the hypothesis of independence could not be rejected for all but the exposure draft on corporate income taxes. Here, the result indicates that auditors and their clients had the same disposition towards the proposed exposure draft on taxes. The same could be said for auditor/client positions on the statement of changes in financial position (cash flow) on which auditors and their clients were in agreement 92% of the times. There is no Chi-Square test result because of the zeroes in two cells of the contingency table for that exposure draft. While the test of independence on an individual exposure draft basis is largely insignificant, Tables 1b and 1e show that majority of responding corporations had the same disposition towards the core issues of the proposal in eight out of the ten exposure drafts used for the analysis. This may partly explain why the overall results indicates dependence, although on an individual exposure draft basis, significant dependence is largely found to be absent. If auditors influence their clients' responses, would it be that they make their positions on the standards known first and try to get their clients on board? Further review of the response letters (Table 1b section 3) again indicates that clients overall responded first to the exposure drafts under review in seven out of ten cases. What is evident from these results is that the decision to respond to the issues raised in new exposure drafts is made by respondents irrespective of their relationship with other prospective respondents to the same exposure drafts. The perception of Big Eight/Five auditors' domination also arises from the fact that they are seen to be too involved in the process. Naturally, because of the nature of their work and better understanding of the theories, techniques,

and practical issues surrounding accounting proposals, they are bound to indicate their stance on issues they understand better more often than other users. This is borne out by their active participation in the standards setting process from Table 1b, section 1 and Table 1c. They participate more often than other accounting firms. However, the Big Eight/Five accounting firms were not often unanimous in their dispositions towards the proposals as seen in Table 1d. That they may influence other participants to tow their line of thought relative to new standards is not empirically evident in this study. Indeed the significant similarities in responses of auditors and their clients to the exposure draft on income taxes and the statement of changes in financial position (cash flow statement) may be best explained by the nature of the subject matter of those proposed standards themselves. The draft contents could arouse similar responses from auditors and their clients rather than by any attempt at collusion between auditors and their clients to influence the outcomes of eventual standards.

CONCLUSION

The intention behind the use of due process in accounting standards setting is to bring the views of many interested users of accounting information to bear on the eventual standards. It is expected that this would ensure greater acceptance of eventual standards and help to avoid the costs of enforcement that may, otherwise, be high. Hence the process is being used in Canada even though the CICA has sole authority over the issuing of standards to be followed by publicly traded companies. The empirical evidence presented in this study indicates that there is broad audience participation in the standard setting process in Canada although accountants, accounting firms and their related organizations are the most prominent ones, just as they are in the USA and elsewhere. Also, evidence of the large auditing firms additionally influencing the process through their clients is not indicated by the results of this study, especially on an individual exposure draft by exposure draft basis. When all responses were grouped together without regard to the exposure draft, the test of independence of auditor-client response was rejected. However, that was an inadequate determinant of auditor-client dependence since the ultimate goal of auditors' attempt at influencing their clients would be to influence the outcome of individual standards. Hence it can be concluded from the results of this study that the nature of responses is not easily predictable. Furthermore, independent firm and corporate motivations explain the decision to participate in the accounting standards setting process in Canada to a significant extent. There may be other reasons for this to happen as well.

Table 1a : Participation by Constituent Groups

Group	Number of Letters	Percentage
1. Accountants and Accounting Firms	1184	34.3%
2. Provincial Accounting Bodies	334	9.7%
3. Government and Security Regulators	473	13.7%
4. Public corporations	894	25.9%
5. Crown Corporations	136	3.9%
6. Other Professional Organizations	117	3.4%
7. Academic Academicians	65	1.9%
8. Other non- accounting individuals	199	5.8%
9. Banks	46	1.3%
Total	3448	100%

Table 1b: Auditor-Client Participation in Exposure Drafts Responses

Response Frequency by Auditor Size (Max 10)			Big 8/5 Auditor-Client Agreement		Who Responds First (Big 8/5 Auditor-Client)	
Firm Size	Once	2-5 Times	>5 Times	Most Clients Agree	Most Client Disagree	Auditor Responds First
Big 8/5	0	1	7	8	2	3
Other	28	15	9			

Table 1c: Audit Firms' Participation in Exposure Draft Responses

Firm	ITC	SCFP	Pension	Revenue	Portfolio	Taxes	FOFS	Pension	PPE	C.Assets	All
Big 8	8	7	8	6	5	7	4	6	5	6	62
Other	19	13	7	10	18	17	20	10	21	7	142

Table 1d: Pattern of Agreement Among Responding Big 8/5 Accounting Firms

ITC	SCFP		Pension		Revenue		Portfolio		Taxes		FOFS		Pension 2		PPE		C.Assets	
	A	D	A	D	A	D	A	D	A	D	A	D	A	D	A	D	A	D
3	5	7	0	6	2	3	3	0	5	0	7	1	3	3	5	0	1	5

Table 1e: Pattern of Majority of Responding Firms Agreement with position of their Big 8/5 Auditors

ITC	SCFP		Pension		Revenue		Portfolio		Taxes		FOFS		Pension 2		PPE		C.Assets	
	A	D	A	D	A	D	A	D	A	D	A	D	A	D	A	D	A	D
5	3	6	1	5	3	4	2	3	2	6	1	1	3	6	0	2	3	0

A = Agree; D = Disagree.

Table 2: Test of Auditor-Client Independence

	ITC		SCFP		Pension		Revenue		Portfolio		Taxes		FOFS		Pension		PPE		C Assets		Overall	
C/A	F	A	F	A	F	A	F	A	F	A	F	A	F	A	F	A	F	A	F	A	F	A
F	8	11	48	0	22	9	16	8	1	14	0	15	5	6	9	0	12	4	8	5	129	72
A	10	27	4	0	19	9	1	0	0	13	1	58	3	1	3	0	7	6	5	22	53	136
P2	1.31		0		0.7		0.49		0.89		0.26		1.03		0		1.42		7.40**		51.11**	

**significant at <.01

C/A = Company and Auditor responses; company responses in columns, auditor responses across. F = For; A = Against.

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