



Self-interest in lobbying on accounting standards: The case of a new lease standard.

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Master thesis Accountancy

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Preface

This thesis is the final piece of my Master in Accountancy. It has been quite a heavy but also a very interesting year with this thesis as final a test. The thesis is about the motivation of firms to participate in the standard setting process. While the standard setters expect firms to do so in public interest, this paper shows that most firms criticize proposals for new accounting standards only in their own interest.

I came to this topic after a lot of research, switching and consultation with my supervisor. From the beginning it was clear that I wanted to do something with the new lease proposal, since I thought this was an interesting and a current topic. Since investigating the implications of this proposal was quite difficult because it had not yet been introduced, I started looking at the proposal itself and the process behind issuing such a proposal. In this way I finally arrived at the comment letters sent on the proposal and found out about prior literature to participate in this comment letter process. I also found out about prior research that suggested that firms with more self-interest were more likely to lobby than other firms. Since I only wanted to focus on the received comment letters on the lease proposal, I decided to investigate self-interest within these comment letters, so self-interest in the content of comment letters.

There are some people without whom I could not have completed this thesis. First of all I am very grateful to my supervisor Prof. dr. L.G. van der Tas RA from Tilburg University. He gave me the freedom to investigate the topic in the way I thought it would be interesting, but at times I got stuck with something, he always made time to help me out and find an alternative solution. He also provided me with critical, but more important also with, useful corrections and suggestions which certainly improved this thesis.

Furthermore I would like to thank Ernst & Young Accountants Eindhoven a lot for giving me the opportunity to combine an internship with the writing of my thesis. I am also very grateful to them for the facilities they offered me, which made it possible for me to fully focus on my thesis.

Last but not least I would like to thank my parents for their interest and support during the months I was writing my thesis and for giving me the possibility to fully focus on this process.

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Summary

This study investigates the influence of self-interest on the positions taken by firms in the lobbying process on a new lease standard. This new lease proposal is about capitalizing lease rights and commitments. Comment letters are used as a proxy for participation behavior in the standard setting process. The study examines the comment letters sent on the discussion paper and exposure draft leases and links the received comments to certain firm characteristics that are considered to indicate the amount of self-interest of firms. The results indicate that the amount of lease commitments a firm has and the solvency ratio of a firm have a big influence on the comments firms give on the new lease proposal. Since these two characteristics are considered to be indicators of self-interest, the results indicate that the comments received by the standard setters on a new standard are biased a lot by the self-interest of firms. Having EBIT as key performance indicator or being listed in the US were not found to be determinants of the comments given. With regard to timing, this paper finds that comment letters sent in an early phase of the standard setting process are less biased by self-interest than comment letters sent in a later phase. Overall this study finds that, despite of standard setters expectations, the public participation in the standard setting process is mostly driven by self-interest of firms instead of the public interest.

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1 Introduction

In March 2009 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly published the discussion paper Leases. In this discussion paper, the FASB and IASB jointly initiated a project to develop a new approach to lease accounting that would ensure that assets and liabilities arising from leases are recognized in the statement of financial position. This should be required from firms to get a more complete and understandable picture of a firm's leasing activities and the rights and obligations that are connected to them.

Based on the discussion paper and the exposure draft, which continued on the discussion paper in 2010, a lot of comment letters were received by the IASB and the FASB. These comment letters are part of the participation process of parties that have an interest in the new accounting standard. Some prior research suggests that comment letters prepared by firms and organizations are mostly driven by their own interest. An interesting question related to the comment letters on the new lease standard would therefore be whether the comments can be linked to the self interests of the senders. This paper will focus only on the comment letters sent by lessees, firms that lease assets from other firms, and aims to find out whether there is a relation between the comments sent on the proposal and the characteristics of firms that sent these comment letters. In other words; what is the influence of certain firm characteristics on the comments sent on proposals for new accounting standards, when these characteristics give firms a self-interest in this participation process.

Public participation in the standard setting process is very important for standard setters, that is why Barth (2000) and Cooper and Robson (2006) encouraged academics to gain more insight into drivers and characteristics of participants in the standard setting process. Up to now this participation research has mainly focused on the relation between firm characteristics and the decision to lobby or not. Only few papers have investigated the relation between the characteristics of a firm and the contents of the comment letters sent on a particular proposal. This paper focuses on this last relationship and is therefore an expansion of existing literature. Other reasons why this paper expands prior literature are that prior, comparable research uses relatively old data (Wilson & Ahmed, 2002; Hill et al., 2002; Georgiou & Roberts, 2004;

Dhaliwal, 1982), from the years 1996 and earlier, and because this paper uses different variables and a different measurement model. This paper also has practical relevance, because it examines whether the comment letter process of the FASB and IASB is a properly working mechanism. The standard setters rely a lot on this comment letter process, but how useful is this system when participants mostly react in their own interest instead of in an objective and reliable way.

This study shows that firms that are asked by standard setters to comment on a particular standard, do not comment in public interest, but in their own interest. So the comments received by the standard setters do not only include objective feedback, but also a lot of self interest, which makes it difficult to estimate how good a new standard really is. These findings about self interest are based on a sample of 204 comment letters sent by firms on the discussion paper leases (55) in 2009 and on the exposure draft leases (149) in 2010. These comment letters revealed that firms with a bad solvency ratio and firms with relatively much future lease commitments, more often commented negatively to the proposal than other firms. Since literature suggests that firms with a bad solvency ratio and much lease commitments are harmed more by the new lease proposal, the results indicate that self-interest influences the content of comment letters sent. A second finding of this study is about the influence of timing on the amount of self interest in the comment letters. To come to a conclusion about this topic, comment letters sent on the discussion paper leases (2009) were compared to the comment letters on the exposure draft (2010). This study finds that comment letters sent in an earlier stage of the standard setting process (on the discussion paper) are less biased by self-interest of firms than comment letters sent in a later stage (on the exposure draft).

The paper proceeds as follows. In the second chapter the process of public participation and the main point of the new lease proposal are outlined, the third chapter discusses prior literature and the developed hypotheses, chapter four introduces the sample, the variables and the research methods used, the fifth chapter discusses the results of the tests and the sixth and last chapter comprises a conclusion and some discussion points.

2 Public participation and the new lease proposal

2.1 *Public participation*

The IASB and FASB are organizations founded for establishing standards of financial accounting that govern the preparation of financial reports. The IASB is the independent standard-setting body responsible for the development and publication of the IFRS standards. The FASB is the standard setter for US-GAAP standards. These two organizations are cooperating more and more to make the different accounting standards in the world come closer to each other. The new lease standard is also a joint project, so since these two organizations are very much comparable and they are working together in this case, they will be mentioned together as the standard setters after this.

In fulfilling their standard-setting duties, the standard setters try to be as open and transparent as possible. This is necessary because no elected or governmental authority is present to monitor the members. In order to keep their procedures transparent, public participation in this process is demanded. Public participation can be divided into participation through formal and participation through informal channels (Jorissen et al., 2010). According to Morris (1986) formal participation includes written submissions, position papers, questionnaire responses and membership of the standard-setting board. Informal participation includes for example luncheon discussions, telephone conversations and other word-of-mouth, non official communications. Obtaining evidence of informal participation is difficult, because such an activity is often not directly observable. For this reason and because formal participation methods gain in importance, since board members are more and more constrained to their independence, previous studies are mostly based on the formal ways of participation (Tutticci et al., 1994; Jorissen et al., 2010).

One formal way of participation is asking stakeholders to write comment letters when a new standard is being developed. When a new standard is developed, the first conceptual ideas about this new standard are published in a discussion paper. When this is published, stakeholders are asked to comment on the conceptual ideas about a new standard as discussed this paper. Stakeholders that are asked to comment on these papers include different groups of respondents; the accounting profession, other standard setters, academics and firms. When comments are

received, analyzed and possibly applied, the standard setters publish an exposure draft of the new standard, which is a little more detailed. Stakeholders are also asked to comment on this proposal. Because the standard setters have some general questions they want everybody to answer on in their comment letter, these questions are included in the discussion paper and the exposure draft. All the proposals and comment letters are published on the websites of the standard setters in order to keep the standard setting process open and transparent. After the comments on the exposure draft are analyzed, the standard setter issues an update to inform stakeholders about the amendments being made following the comments received.

Recently, the proposal for the new lease standard has been adjusted a lot, partly caused by the comment letters received. These changes moved the proposal more in the direction of the current accounting standards for leases and less to the right-of-use model. These developments are interesting to remark, but are not important for this paper, since this paper only focuses on the discussion paper, the exposure draft and the comment letters sent on these proposals and these have not changed.

2.2 *The new lease proposal*

This paper focuses on the public participation in a proposal for a new lease standard. The process of setting this new standard involved a discussion paper (2009) as well as an exposure draft (2010). On both of these, comment letters were received by the standard setters.

The existing lease accounting model has been criticized for failing to meet the needs of users of financial statements. Most of the criticism was based on the fact that it does not provide a faithful representation of leasing transactions. In particular it omits relevant information about rights and obligations related to lease agreements. These rights and obligations could be presented by capitalizing them on the balance sheet. In the existing lease accounting model, leases are divided into operating and financing leases. For finance leases capitalization is already partially mandated, operating leases do not require any capitalization. These two categories in leasing have been criticized for their complexity and because they allow firms to account for similar transactions in different ways, which reduces comparability for users. Another criticism on the existing standard is that many users feel that lease contracts give rise to assets and liabilities. Since these are not recorded in the financial statements, users start making adjustments

themselves, which leads to wrong numbers because users do not have sufficient information. That is why the standard setters developed a new standard for lease accounting that would ensure that assets and liabilities arising under leases are recognized in the balance sheet. With this new standard, the two categories no longer exist, all leases will have to be accounted for in about the same way (Exposure draft leases, 2010; Discussion paper, 2009).

As described above, to come to a new lease standard, the standard setters first issued a discussion paper which was later followed by an exposure draft. Before issuing this exposure draft, the comments received on the discussion paper were analyzed and taken into account. The comments received on the discussion paper led to several changes in the exposure draft, but the main proposal about capitalizing leases remained the same. The only change in the exposure draft compared to the discussion paper was that the discussion paper wanted to capitalize a little more than the exposure draft, but this is not important for this study, since this study only focuses on the main proposal of capitalizing leases. Since both publications include the same main proposal, the comment letters received on both will also be on the same content. As all comment letters mention the same main proposal, capitalizing leases, both comment letters on the discussion paper as on the exposure draft are useful for the sample.

The new lease proposal as described in the discussion paper and the exposure draft, is quite an extensive one. In order to keep the main issue plain, this paper will only focus on the major points of the proposal. The standard has new requirements for both lessees (firms that lease assets from other firms) and lessors (firms that lease assets to other firms). The main proposal in the discussion paper and the exposure draft is that lessees and lessors should apply a right-of-use model in accounting for all leases. This right-of-use model argues that when a lessee leases an asset, and he gets the right to use it, the lessee has received an economic resource, because this allows him to generate cash flows. The model further argues that the lessee has control over the resource, this control results from a past event –signing the lease contract- and this resource will generate future economic benefits. Since all criteria for an asset are met, the board concludes that this right-of-use should be put on the balance sheet as an asset. At the same time, for the lessor the opposite is the case. Since the leased asset can only be recognized by one party, the lessor should either derecognize the asset from his balance sheet or should recognize a lease liability as a performance obligation, which neutralizes the asset. Since the right-of-use for the lessee is not

for free, the amounts to be paid for the lease are captured in a contract. Since this gives the lessee a present obligation to pay rentals, this obligation arises from a past event –signing the contract- and the obligation is expected to result in cash outflows, the board concludes that all criteria for a liability are met and that these future payments should also be capitalized. Again, for the lessor the opposite is applicable. The lessor has the right to receive lease payments in the future. Since these result from a past event –signing the contract- and are expected to generate future cash flows, these should be capitalized as an asset. By doing this, the liability of the lessee and the asset of the lessor are balanced again. (Discussion paper, 2009, Exposure draft, 2010)

In practice this new standard will require firms with leases to add significant amounts of assets and liabilities to their balance sheet. This will have a significant effect on all kind of performance ratios these firms have to report. Since this new standard will have significant effects on a lot of firms and since these effects are relatively easy to point out, this proposal is very suitable to test for self-interest in the participation process.

3 Literature review and Hypotheses development

In 1978 Solomons already mentioned it: standard-setting is not a sole technical or theoretical issue but has become a political process. All related interested parties like preparers of financial statements, auditors and users have different and often conflicting interests. These conflicting interests make it almost impossible to develop an accounting standard that is satisfactory to all parties. Therefore interested parties will try to persuade the standard-setters to make rules that maximize their utility. The actions taken by interested parties to persuade the standard-setters are often referred as participation (Yu, 2006).

3.1 *Definitions*

A lot of research has been done on public participation in the past. In literature, public participation is also called lobbying. Several different definitions of public participation have been defined in this prior research. Some studies defined participation narrowly as the submission of comment letters (Francis, 1987; MacArthur, 1996). Others defined it a little broader as actions taken by interested parties to influence a rule-making body (Sutton, 1984). Georgiou and Roberts (2004) are more concrete in their definition; participation consists of writing comment letters, formal and informal meetings, and conversations with standard setters. Another way to define participation is as a range of behaviors that starts with direct participation in the standard setting process, but may also involve public relations efforts that seek to influence parties on which the standard setter is dependent (Elbannan et al., 2006).

Although participation includes more than just comment letters, this paper will only focus on the comment letters and use these as a proxy for participation behavior. Georgiou and Roberts (2004) found a strong link between the use of comment letters and the use of other participation methods. Based on this, they concluded in their study that comment letters are a good proxy for participation. In order to maximize the probability of influencing the standard-setter, companies employ a number of participation methods. The companies that use these methods are likely to be those that also use comment letters. These findings suggest that comment letters are likely to be a good proxy of corporate participation activities.

Literature based on participation and comment letters has been criticized in the past. Holthausen and Leftwich (1983) state that it is difficult to determine an overall participation

position on a proposal, because lobbyists may support some parts of a proposal while opposing others. This critique is not relevant to this paper, because this paper only examines one particular part of the lease proposal, namely the part about the general idea of capitalizing leases. This part is separately discussed and questioned in the comment letters and therefore a clear opinion about this particular subject can be easily obtained from the comment letters.

3.2 *General prior research*

Prior research has revealed that participation on proposals for new accounting standards does have an effect on the further standard setting process. For example Kreuze et al. (1993) find in their study on participation for a new accounting standard, that issues that were strongly criticized by respondents were modified more often before the standard was definitely issued. They further found that none of the issues that were favored by the respondents were modified by the standard setter. Sutton (1984) also mentions some successful participation cases in his paper. These results show that participation does have an effect and that is why it is still being used by a lot of firms.

Much of prior research has focused on characteristics of firms that lobby versus firms that do not lobby. Only few general conclusions can be drawn from this. Company size is found to be a determinant of participation behavior, bigger firms are more likely to lobby than small firms (Ndubizu et al., 1993; Francis, 1987; Ang et al., 2000; Georgiou G. & Roberts C.B., 2004; Jorissen et al. 2010). One suggested reason for this is that economic consequences of new standards are most heavily felt by bigger firms, because of this the potential benefits of participation will be larger for these firms and are more likely to outweigh the costs of participation. Another suggested reason is that bigger firms have a higher probability of influencing the standard setting process (Sutton, 1984). The importance of debt and management compensation schemes on participation behavior have also been researched a lot, but no general conclusions were reached on these topics (Deakin, 1989; Ang et al. 2000; Hill et al. 2002; Dhaliwal 1982; Dechow, 1996).

Another interesting subject from prior participation research has to do with the timing of participation. Prior research found significant differences in timing of participation in the participation process of different groups of respondents. The accounting profession, the standard setters and the academics focus their participation at an earlier stage in the standard setting process, in this case the discussion paper. Preparers however concentrate their efforts more on a

later stage in the process, in this case the exposure draft (Jorissen et al., 2010). An explanation for this may be that a discussion paper usually is more conceptual than the discussion paper. The accounting profession, standard setters and academics are more conceptual thinkers, so for them these are interesting ideas to comment on. For preparers (firms that prepare financial statements) however these papers are not concrete enough and do not give them direct incentives to react on these. As soon as these proposals become more concrete, in this case when the exposure draft is published, preparers start to explore the consequences the new standard will have for them. These potential consequences provide preparers with incentives to start participating. The fact that preparers start participating only after they noticed possible consequences suggests that they are acting in their own interest. Based on this, it is expected that the amount of self interest will be higher for comment letters on the exposure draft than on the discussion paper.

H1: Comments sent on the exposure draft will explain more of the variance in the self-interest model (higher R-square), than comments sent on the discussion paper.

In prior research three main approaches have been used by researchers to investigate the motives of firms to lobby for certain standards. Using the first approach, characteristics of firms that lobbied in favor and against a particular proposal are compared. The second is done by comparing characteristics of firms that lobbied and firms that did not. The third and final approach is to examine the reasons given by firms for their decision to lobby or not, or why they supported a particular position (Georgiou, 2005). In this paper, the first approach will be used, comparing characteristics of firms that lobbied for and against the proposal for a new lease standard. As in the papers of Hill et al. (2002) and Sutton (1988), firms that did not lobby at all are not included in the sample.

A lot of prior research has been done on behavior of people and firms, and on the extent to which self interest influences this behavior. These self-interest motives and the two most influential studies on this topic are discussed in the next part.

3.3 *Self interest*

Both the agency theory (see Fama, 1980) and the theory of rational behavior (see Klein, 1946), suggest that each stakeholder group will try to influence the standard setter's decisions in a way that maximizes their own interests relative to those of other stakeholders.

"Firm's participation activity is correlated with management's anticipated wealth", that is what King & O'Keefe (1986) concluded in their paper. In other words, management will lobby in the way that is most beneficial for themselves and their firms and not in the way that is best for society.

Already in 1957 Downs came to a comparable conclusion: people do not act because they want the best for everybody, but just because they want the best for themselves. Downs concluded this from a study on voting behavior of people. He found that people do not vote because it is their social responsibility to vote, but just to get the most personal benefits. Based on this paper of Downs, Sutton (1984) made his cost-benefit model which tries to explain the participation in the participation process as a function of perceived benefits over the costs of participation. This study of Sutton is one of the two most influential studies in participation research. The second important study in the participation literature is the study of Watts and Zimmerman (1986), which defines their positivist approach. This approach states that the participation in the participation process is dependent on the potential economic and social consequences of a proposed standard on a company. Additional to this, Jorissen et al. (2010) and Tandy and Wilburn (1992) find that the participation of firms in the participation process is dependent on the topic of a standard. Firms that are hardly influenced or damaged by a new standard are less likely to react on the proposal. This is not in line with the purpose of the comment letters, which is to get a fair and representative view of what is the overall opinion on a proposal. If only the firms that have an own interest in the standard react on a proposal, the standard setters do not get the fair and representative overall view they were looking for.

Hill et al. (2002) examined the participation behavior of managers on a new accounting standard, which mandates firms to disclose the amount of stock-based compensation paid to their managers. They suggest in their paper that managers believe that stakeholders, such as labor unions or government regulators, may react adversely to the disclosure of this information. For example labor unions may demand for higher wages when discovering high management

compensation in a firm. These potential actions would be bad for the firm and for the manager because of the higher costs and the cash flowing out of the company. This is why managers with much stock-based compensation lobbied more often against this new standard than other managers (Hill et al., 2002). The more wealth management of a firm holds in the form of stock options, the more likely this firm will oppose to this new standard. A reason for this is that disclosure of this information may lead to public demands for changes in compensation packages, which in turn may lead to lower stock prices (Dechow et al. 1996). This supports the view that firms or managers of firms lobby in their own interest and not in the interest of society.

The main question to be answered in this paper is; what is the influence of certain firm characteristics on the comments sent on proposals for new accounting standards, when these characteristics give firms a self-interest in this participation process. Based on, or related to the studies of Sutton (1984) and Watts and Zimmerman (1986), a lot more studies have been conducted. The most important findings will be discussed next, this is done by dividing them over the two approaches.

3.3.1 Cost-benefit approach

The general idea of the cost-benefit approach is that people will only take action when the expected benefits of this action will be bigger than the costs they need to face. When calculating the expected benefits of participation, the probability that the participation will have an effect on the standard setting process is taken into account. When this is applied to participation, firms will only lobby for a particular standard when the expected benefits of this participation process will be bigger than the costs they face during this participation process. Related to this, also the amount spent on participation will be based on the potential benefits of participation. The greater the opportunity cost of not participation, the larger the expenditure on participation will be (Sutton, 1984; Francis, 1987).

Gaa (1988) defined the most important costs and benefits firms face in their decision to lobby. As most important benefit he identified the expected advantage to be gained from a favorable outcome of the standard setting process. The two most important costs faced by firms during the participation process are the costs of participation, such as preparing a comment letter and/or making a personal appearance at a public hearing, and the costs of obtaining information,

including keeping track of the FASB's/IASB's agenda, reading documents and performing research upon the topics to comment on.

To be persuasive, a lobbyist must be well informed about the policy area in which he wishes to exert influence. Therefore being a lobbyist requires a lot of information gathering, which makes the cost of participation relatively high (Downs, 1957). The fact that preparers are likely to be wealthier than users combined with these relatively high costs makes that preparers are more likely to lobby than the users of financial statements (Wilburns, 1992; Jorissen et al., 2010). Another reason why preparers are more likely to lobby is their dependency on few particular sources. A change in one of those sources will affect them a lot, because their income is very dependent on it. Users of financial statements however are dependent of a lot of different policy areas, hence any change in one of those areas is not very significant to them. Because of this, the benefits a user can generate by getting informed and by participation simply does not recompense him for the costs that need to be made. (Sutton 1984; Downs, 1957 & Francis, 1987). Olson (1965) further explains this by stating that participation will only take place if the lobbyist's share of expected total benefits is bigger than the costs of participation that he bears. In these circumstances, large producers enjoy an advantage over small producers and users because a relative small change in a policy may have a major absolute influence on their statements. A final reason why preparers are more likely to lobby than consumers arises from the fact that they are better able to cooperate in the participation process, because their economic interests are more homogeneous than those of users (Sutton, 1984).

Sutton (1984) introduced the cost-benefit approach in the participation literature, but he based his theory on a framework stemming from the paper of Downs (1957). Downs's paper is about the voting behavior of people, but Sutton (1984) shows that this behavior can be explained in the same way as the participation behavior of companies. Downs (1957) argues that a rational individual will only vote if the perceived benefits of voting exceed the costs of voting. In examining the expected benefits of voting, an individual takes into account the expected utility he receives from his party, but also the likelihood that his vote will sway the outcome of the election. Only if the product of these two estimates exceeds the costs of voting, it will be rational for the individual to vote. This theory of voting can be linked to that of participation because they

share some characteristics of an investment good (Sutton, 1984). Individuals invest in an activity in the expectation of future benefits. Participation can be seen as a form of investing. Participation, like investing, requires a cost, the effort made by the interested party, and it is done because of expected future benefits (influencing a particular standard). Other shared characteristics between the voting and participation process are the limited choice of issues to two (to lobby or not to lobby), a rational individual making the decision and the tradeoff between costs and benefits (Sutton, 1984).

Now that the link between the voting and participation process is explained, the cost-benefit model of Downs can be outlined further. Downs (1957) studied the voting behavior of people in a democracy. He starts his paper by explaining that every person has both a social function and a private motive. The social function of people in the voting process is voting for a party to make sure the country is governed by the best government. However it is the private motive of the people that motivates them to vote, they carry out their social function primarily as a means of attaining personal income, prestige or power. People act in this way because they are rational, their decision is based on a comparison of the utility each alternative offers them (Downs, 1957). This works about the same for participation. The social function of the lobbyists is trying to influence the standard setting process in the way that is the best for most people, or in the way that is best for the overall accounting standards. The lobbyists however will act rational and lobby primarily in the way that is best for themselves (Sutton, 1984).

Tandy and Wilburn (1996) support the research of Sutton (1984). They conclude in their paper that the type of standard under consideration significantly affects the number of responses from the industry. The industry lobbied more for particular standards when these were more important for them. This suggests that the costs and especially the expected benefits of participation differ between types of standards. This supports the cost-benefit approach because those standards for which the benefits outweigh the costs to a bigger extent, are lobbied more for than other standards.

With the introduction of the new lease standard, firms with a lot of leases will be affected a lot more than firms with only few leases. With the new standard, the liabilities of firms with leases will rise. For firms with only few leases this effect will only be small. For firms with a lot of leases however, this effect will be very large. Ratios of these firms will be harmed a lot, which

makes their expected benefits of public participation larger. Firms with only few leases are hardly influenced, so these firms are expected to comment on the proposal in a social manner and not in a manner that is only best for their own interest. Firms with a lot of leases however are influenced a lot in a negative way and therefore these firms are expected to comment in their own interest, which in this case is negatively, to the proposal.

H2: Firms with relatively more leases (total leases/total assets > 5%) comment “not agreed” more often than firms with relatively less leases.

3.3.2 *Economic consequences approach*

The economic consequences approach is based on the belief that firms or management of firms act in that way that is most beneficial for themselves. When a new accounting standard will have a negative influence on the firm or the manager, they are expected to lobby against this new standard. So the economic consequences of a new standard will significantly influence the opinion of a manager or a firm on that standard (Watts and Zimmerman, 1978).

Watts and Zimmerman (1978) believe the management of a corporation plays a central role in the determination of standards. Moonitz (1974) supports this view: “management is central to any discussion of financial reporting, whether at the statutory or regulatory level, or at the level of official pronouncements of accounting bodies”. According to Watts and Zimmerman (1978) management’s influence on the determination of standards by participation is mostly driven by their own firm’s interest. The most important factors management takes into account when judging a new standard are political costs, information production costs and the impact on accounting numbers.

By political costs Watts and Zimmerman (1978) mean the idea that the political sector tries to redistribute wealth. Groups or corporations that are considered to be wealthy will be charged more often with all different demands, like labor unions demanding higher wages, when large profits are reported by a firm. By keeping reported earnings low, managers try to keep the money within the corporation and prevent cash flows from going down (Wilson and Ahmed, 2002). One way for managers to keep reported earnings low is by opposing to standards that may lead to higher reported earnings. Managers trying to keep reported earnings low may sound strange, since this number is often used as a measure of their performance. However, most managers also

have stock or option compensation plans for which it is profitable to keep the money within the company. Another reason for managers to act in this way is to keep shareholders and investors satisfied (Watts and Zimmerman, 19878). When this theory is applied to the new lease standard, it is expected that firms with EBIT as a key performance indicator will not agree with the new standard. The abbreviation EBIT stands for Earnings Before Interest and Taxes, so this is the profit of a firm before considering interest costs and taxes. Related to this some firms also report EBITDA or EBITDAR, these exclude the same costs from reported profit plus Depreciation, Amortization and Rent costs. These three earnings numbers will all be captured under EBIT after this. Having EBIT as a key performance indicator means that users who want to examine the wealth of the firm will often base their first opinion on EBIT. The new standard will shift costs from lease costs to interest costs, caused by the capitalization, which leads to an increase in EBIT and related earnings numbers. So users will conclude, based on the EBIT number, that the firm has become wealthier and may put some extra demands on the firm. Based on this, and on literature discussed above, it is expected that managers will try to keep EBIT low. To do this, they will try to prevent the new lease standard from being introduced by opposing to the proposal.

H3a: Firms that have EBIT(DAR) as key performance indicator (KPI) comment “not agreed” more often than firms that do not have this KPI.

However, literature has also investigated this variable from a different perspective. For a lot of managers a major component of their compensation is based on an incentive bonus plan. Since these plans are usually based on reported income numbers, managers have an incentive to increase these reported income numbers (Watts and Zimmerman, 1978). Furthermore firms and managers want the firm to look as good as possible to the outside world by showing good results on performance criteria (key performance indicators or debt covenant criteria). Looking good is important to keep investors and debt holders satisfied, but also when considering extra debt financing. The more negative the impact of an accounting standard on performance criteria (KPI/debt covenants) valued by powerful stakeholders, the more likely firms will initiate action against this standard (Elbannan, 2006) (prop. 10). On the other hand, when a new standard

positively influences a specific ratio or number on which an investor bases his estimation of firm performance, the firm is more likely to lobby positively for this new standard. In the case of the new lease standard, EBIT will be positively influenced. It is therefore expected that firms that have EBIT as key performance indicator will comment positively on this proposal.

H3b: Firms that have EBIT(DAR) as key performance indicator (KPI) comment “agreed” more often than firms that do not have this KPI.

Changes in accounting standards are not costless to firms. New accounting standards that either require increased disclosure or a change in accounting methods increase a firm’s information production and bookkeeping costs. These increased costs affect firm’s and management’s wealth negatively, so it is expected that management will lobby against such standards.

The impact on accounting numbers is important to managers because these may be included in all kinds of covenants. A negative impact on these numbers may violate requirements of these covenants resulting in a fine. Another reason to prevent accounting numbers from becoming worse is that they may be part of the compensation contract of the manager, worse numbers will result in less compensation. So standards that may influence accounting numbers negatively will be lobbied against by firms.

Francis (1987) found evidence supportive of this part of the economic consequences approach. He examined the comment letters on a new FASB standard and found that potential adverse effects on a firm’s balance sheet or income statement were significantly associated with their participation behavior. Firms that expected the new standard to be a danger for their debt covenants or expected their expenses to rise because of the new standard, lobbied a lot more than other firms. Francis (1987) concluded that firms will lobby more on proposals when these are a danger for their own interest. A study with similar results is that of Georgiou and Roberts (2004). They find that lobbyists against a proposal that affects debt covenants are more likely to be those firms that face problems with their debt covenants. Firms participation positively for such a proposal are found to be those that do not have problems with their debt covenants.

Prior research has found that debt covenants of firms mostly include a limit on total debt. In most of these covenants this total amount of debt is specified relative to total assets, this relative

number is often referred to as the solvency ratio of a firm (Ramsay and Sidhu, 1998; Whittred and Zimmer, 1986). Wilson and Ahmed (2002) state that these solvency ratios in debt covenants attempt to constrain managers from taking on high levels of debt, thereby ensuring that there are sufficient assets available to debt holders in the event of liquidation. With the introduction of the new lease standard, firms are mandated to capitalize their lease assets and liabilities on their balance sheet. One of the consequences of this capitalization will be that the solvency ratio of firms will become worse. Because of this, firms that already have a bad solvency ratio may come dangerously close to violation of their debt covenants. Another problem for these firms occurs when they are considering extra debt financing, which will become very expensive with a bad solvency ratio. Firms that currently have good solvency ratios will not face major problems as a consequence of the new standard. Firms that already have a bad solvency ratio will be threatened a lot more by the new lease standard and are therefore expected to lobby more against the proposal than other firms.

H4: Firms with a bad solvency comment “not agreed” more often than firms with a good solvency.

H5: Firms that comment “not agreed” will have a lower solvency ratio than firms that comment “agreed”.

4 Research methodology

As discussed before, this paper uses comment letters as a proxy for participation based on Georgiou and Roberts (2004) who recognized it as a good proxy because they found a very strong link between participation and the use of comment letters. To test the hypotheses introduced before, comment letters on the discussion paper and the exposure draft are needed. These comment letters are taken from the websites of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). In total 1087 comment letters were received on the discussion paper (302) and the exposure draft (785). As discussed in chapter two, the main proposal in both the discussion paper and the exposure draft was the same, so since

the comment letters of both react on the same proposal, both can be used in the sample. These comment letters were sent by all different kind of organizations; accounting associations, preparers of financial statements, governments, accounting firms and universities. This paper will only focus on the comment letters from firms that prepare financial statements. From this group only the lessee firms will be included in the sample to align the self interest motives. Comment letters that did not contain a clear opinion about the capitalization proposal were also eliminated from the sample. After removing all comment letters discussed above, 204 comment letters remained in total. The composition process of the sample is summarized in table 1. Table 1 is composed as follows, first comment letters sent by associations and universities are eliminated (ASS), then comment letters from CPA firms and accounting organizations/boards (ACC), after this the comment letters of lessor firms are eliminated (LESSOR) and finally the comment letters without a clear opinion (NOTCLEAR). After these eliminations the samples for hypothesis 1 are composed. To get appropriate samples for the other hypotheses, only the comment letters sent on the exposure draft are used.

Table 1. Overview of the composition process of the sample.

	Discussion paper	Exposure draft	Total
Total comment letters	302	785	1.087
ASS	92	250	342
ACC	80	236	316
LESSOR	45	90	135
NOTCLEAR	<u>30</u>	<u>60</u>	<u>90</u>
Sample	55	149	204

To test hypothesis 1, a sample of comment letters on both the discussion paper and exposure draft is used. Some firms sent comments on the discussion paper as well as on the exposure draft, this is noticed, but to keep the samples comparable these comment letters are included in both samples. For the other hypotheses only the comment letters sent on the exposure draft are used, because these are, according to literature, more self interest biased and therefore more appropriate for this study. After excluding some comment letters that do not mention the

capitalization issue, a final sample of 149 firms is composed, 204 firms to test hypothesis 1 (including comment letters on the discussion paper).

From each comment letter, the opinion on the capitalization of leases is taken. This is the only part of the comment letters that will be used. The comment letters are marked “agreed” (0) when the comment letter gives a positive opinion on the proposal to capitalize leases and “not agreed” (1) when the comment letter gives a negative opinion on the proposal to capitalize leases. From the 204 firms in the sample, 115 firms agreed with the proposal to capitalize leases and 89 firms did not agree with the proposal.

When all the opinions are collected, the financial statements of the firms that sent the comment letters are analyzed. For comment letters on the exposure draft, financial statements of 2010 are taken, for comment letters on the discussion paper, the financial statements of 2009 will be used. Different years are taken on the understanding that the financial statements of these periods would be aligned with management’s expectations and concerns of the effects of the proposal at the time of sending the comment letter, and therefore may explain the comments sent by the firms.

From the financial statements is noted whether EBIT, which also includes EBITDA and EBITDAR, is a key performance indicator to the firm (KPI). The amount of leases relative to the total assets (LEASEPERC) and the amount of debt relative to the amount of total assets, the solvency ratio (SOLV), are also taken from these financial statements. In the variable LEASPERC, leases are defined as the total future lease commitments as stated in the financial statements and the total assets as the amount of total assets as stated in the balance sheet. By taking total future lease commitments, the operational leases are also included in the ratio. The variable SOLV is calculated as the total amount of assets, as reported in the balance sheet, divided by the amount of liabilities reported in the balance sheet. The variable KPI indicates whether a firm has EBIT as a KPI. This is determined by examining the financial statements on whether EBIT is included in the key financial data in the beginning of this report. Since firms listed in the US are not allowed to report EBIT in their financial statements, a control procedure for US listed firms has been performed. An extra variable (AMERICAN) was included in the model indicating whether a firm is US listed or not.

The variables discussed above are used to determine the amount self interest of the firms in the sample. All the variables, dependent and independent, are being measured by using dummy variables. This is done to keep the model and the results clear and not to complicated. These independent variables need to be coded in the same direction as the dependent variable. In this case factors that are expected to cause a “not agreed” answer are coded 1, since the comment “not agreed” is also coded as 1. Since literature is not aligned with respect to the influence of EBIT as a KPI on the comment sent by a firm, this variable does not have a clear direction of influence on the dependent variable. Since it is more likely to belief that firms with EBIT as KPI are positive to this new standard, this variable has been coded 1 when firms do not have this KPI, since this 1 relates to the dependent variable being “not agreed”. Since KPI is expected to be partly explained by the fact whether a firm is US listed or not, the variable to control for this AMERICAN needs to be coded in that way. Firms listed in the US are expected not to have EBIT as KPI, so since not having this KPI is coded 1, firms listed in the US should also be coded 1. For the solvency ratio of firms, a dummy variable is used. This dummy variable serves as a proxy to divide the sample in firms with a bad solvency ratio and firms with a good solvency ratio. The distribution of firms between good and bad solvency takes place at a solvency ratio level of 1,5. This paper assumes that firms that have 1,5 times as much assets as liabilities can be considered to have a solid solvency ratio. Since it is expected that firms with a bad solvency ratio comment “not agreed” more often, firms with a bad solvency ratio, a ratio below 1,5, are coded 1 and firms with a better solvency ratio as 0. The variable LEASEPERC also divides the sample in two parts. One part containing firms with many lease commitments and another part with only few lease commitments. This is also done by means of a dummy variable. This dummy serves as a proxy to divide the sample in firms with many lease commitments and firms with only few lease commitments. The distribution of firms between many lease commitments and few lease commitments takes place at a level of 5%. This paper assumes that firms with lease commitments bigger than 5% of total assets can be considered as firms with relative many lease commitments and so might be significantly influenced by the new lease standard. Since it is expected that firms with a lot of leases comment “not agreed” more often, firms with more leases than 5% of their total assets are coded 1 and firms with less leases 0.

When all the data are collected, the influence of the self interest variables (KPI, AMERICAN, LEASEPERC and SOLV) is tested on the comments that are given in the comment letters (agreed, not agreed). This is done by a logistic regression. A logistic regression is used because the dependent variable is a dichotomous variable and with such a variable a normal regression is not suitable.

Next to this regression a Chi-square test is performed. This test is used when one attempts to explore the relationship between two categorical variables, which is the case in this paper, namely the dependent variable relating to the separate independent variables. Together with this Chi-square test, a Phi coefficient is determined for every relationship between the dependent and an independent variable. This Phi coefficient provides an indication of the strength of the relationship, in a similar way as a correlation coefficient does. This coefficient's value can range from 0 (no relation between variables) to +/- 1 (perfect relation between two variables) and is calculated as Chi-square divided by the numbers of items in the sample, so Chi-square and Phi will give similar results.

Before executing the tests, the independent variables need to be checked for high inter-correlations (multicollinearity). This is done by assessing the correlations between the different independent variables. To do this, the Spearman correlation is used because all variables are measured using an dichotomous scale. For that reason a non-parametric test for correlations was needed (Wilson and Ahmed, 2002), even though the Pearson correlation gave similar results.

Hypothesis 5 is tested separately. This hypothesis aims to find out whether the average solvency ratios are significantly different for firms that agreed with the proposal compared to those that did not agree. To test this, the independent-samples t-test is used, the independent-samples t-test is used instead of the paired-samples t-test because this paper wants to investigate the mean scores of different groups in a sample and not the mean scores of one group in different situations. Before performing the test, the sample is checked for outliers, because these can influence the mean scores a lot. After removing one outlier, for the 83 firms that agreed and the 65 firms that did not agree, the independent-samples t-test is performed.

To test hypothesis 1, two regression analyses are performed. The first is performed with a sample that only includes comment letters sent on the exposure draft and the second test is performed with a sample that only includes comment letters on the discussion paper. To test

whether comment letters sent on the exposure draft can be explained for a bigger extent by self interest than comment letters sent on the discussion paper, the R squares of both models are compared. These R squares indicate the amount of variation in the comments sent is explained by the self-interest variables in the model. Since the sample of the exposure draft includes more comment letters (179) than the discussion paper (55), it may be argued that this causes the higher R square. To control for this, I also test for only 55 randomly chosen comment letters on the exposure draft. As discussed in chapter two, the discussion paper and the exposure draft do not differ on the main proposal which is capitalizing leases. Since only comments on this main proposal are considered, the content of the publications cannot be the cause of any differences in comments received.

5 Results

Before starting the analysis, the independent variables need to be checked for multicollinearity. This is done by checking the Spearman correlations between the variables. The results that were found regarding these correlations are summarized in table 2.

Table 2. Correlation matrix of the independent variables to check for multicollinearity (N = 149)

		KPI	SOLV	LEASEPERC	AMERICAN
KPI	Corr. coefficient	-	-.162 (.049)	-.118 (.151)	-.446 (.000)
SOLV	Corr. coefficient	-.162 (.049)	-	.115 (.164)	.124 (.133)
LEASEPERC	Corr. coefficient	-.118 (.151)	.115 (.164)	-	.222 (.006)
AMERICAN	Corr. coefficient	-.446 (.000)	.124 (.133)	.222 (.006)	-

For interpretation of these results, the guidelines of Cohen (1988) are used. In his paper Cohen rates correlations between (-)0,10 and (-)0,29 as small, between (-)0,30 and (-)0,49 as medium and correlations between (-)0,50 and (-)1,0 as large. Since all correlations, except those between KPI and American, in this sample are below (-)0,29, there are only small inter-correlations between the independent variables. Based on this, it can be concluded that there is no problem of multicollinearity in this model. The very high and significant correlation between KPI and AMERICAN shows that the variable KPI is indeed influenced a lot by firms being listed in the US or not. Since these variables are so highly correlated, they cannot be included in the model together. So the relationship between these two variables has been considered and been found, but to keep the model free from errors, only KPI will be included in the final model.

To test hypothesis 1, two regression tests are performed. The first on a sample with only comment letters on the exposure draft (model 1), the second on a sample that only includes comment letters on the discussion paper (model 2). The following results are obtained from these tests.

Table 3. Results of regressions performed on three different samples, for comparison of R-squares per sample.

	Number of comment letters	Cox & Snell R Square	Nagelkerke R Square
Discussion paper	55	,235	,316
Exposure draft	149	,280	,375
Exposure draft	55 randomly chosen	,328	,446

The results shown in table 3 support hypothesis 1. When the comment letters from the discussion paper are compared to the sample from the exposure draft, the R square of the discussion paper sample is lower. One might argue that this is caused by the bigger sample of the exposure draft, but when the same test is performed on 55 randomly chosen comment letters on the exposure draft, the results become even more convincing. That these R squares are even higher than those of the full exposure draft sample is surprising, but is most likely to be a coincidence.

Summarizing the results as stated above; comment letters on the discussion paper can to a lesser extent be explained by self-interest. So as literature and hypothesis 1 expected, comment letters on the exposure draft are more biased by self-interest than comment letters on the discussion paper.

From the logistic regression on the sample of the exposure draft the following results were obtained.

Table 4. Regression results of the influence of the self-interest variables on the comments sent on the exposure draft (N = 149)

	KPI	SOLV	LEASE	constant	Cox & Snell R ²	Nagelkerke R ²
Beta	-,550	1,635	1,771	-1,388	0,280	0,375
Sig.	(,188)	(,000)	(,000)	(,003)		

Table 5. Results of the Chi-Square tests on relationships within the model.

Relation	Pearson Chi-Square	Phi	Significance
Comment - SOLV	19,705	,364	,000
Comment – KPI	5,251	-,188	,022
Comment- LEASE	24,067	,402	,000

Hypothesis 2 expects firms with relatively more leases to comment “not agreed” more often than firms with relatively less leases. The results from the regression (table 4) suggest that the relationship between COMMENT and LEASE is as predicted in the hypothesis. The relationship is significant at the 1% significance level. The Phi statistic (table 5) also finds a relatively strong positive relationship between the amount of leases and the comment “not agreed” at the significance level of 1%. So hypothesis 2 is supported by both tests.

Regarding hypothesis 3a and 3b, which predict the relation between EBIT as a key performance indicator and the comment given, the results are not significant. The regression results (table 4) suggest a negative relationship, but the variable KPI is insignificant (0,188), so no conclusion can be drawn from this. The Phi statistic (table 5) finds a small negative relationship between not having EBIT as KPI and the comment “not agreed”. The Phi statistic finds this at a significance level of 5%. However the Phi statistic only tests the direct relation between KPI and the comment given. This direct relation seems significant, but as soon as other variables are included, as in the regression, the significance disappears. This signals that a relation between the two variables exists, but this is not a causal relation, so hypothesis 3 is not supported.

Table 6. Results of the independent-samples t-test

Comment	N	Mean	Std. Deviation	Sig.
Not agreed	65	1,8402	0,8924	0,087
Agreed	83	2,1078	0,9695	

Hypotheses 4 and 5 test the relationship between the solvency ratio of a firm and the comment given on the exposure draft. Results from the regression (table 4) support hypothesis 4, since these results indicate a positive relationship between a bad solvency ratio and the comment

“not agreed”. Since the results are significant at 1%, hypothesis 4 is supported by this regression. The Phi statistic (table 5) finds a relatively strong relationship between the solvency ratio and the comment given. This relationship is also significant at 1% and therefore also supportive for hypothesis 4. To test hypothesis 5, the average solvency ratios of firms that agreed with the standard were compared to those that did not agree. This was done by an independent-samples t-test. Results from this test are listed in table 6. In total 148 comment letters are used for this test, the 149 letters on the exposure draft, minus one outlier. The results indicate that there is quite a difference between the average solvency ratios of firms that agreed and firms that did not agree. However when considering the significance of the results, these do not seem very convincing. Since the results of this test are not significant at 5%, these results are not useful in supporting hypothesis 5. Concluding on the relationship between solvency ratio and the comment given on the exposure draft, the two methods used are not aligned. But since the regression results are very supportive and the significance of the t-test is not too bad, the overall conclusion on this topic is that there is a positive relationship between a bad solvency ratio and the comment “not agreed” given on the exposure draft.

6 Conclusion and Discussion

This study was designed to get an insight in what drives firms in their comments on new accounting standards. The main question related to this is whether firms are acting in public interest or in their own interest. This study is based on the comment letters received by the FASB on the exposure draft Leases. The main point of this exposure draft is that all lease commitments will have to be capitalized in the future. To test self-interest, several firm characteristics are identified, which are intended to give certain firms more interest in the new standard than other firms. Firms with such characteristics are expected to comment differently on the exposure draft than other firms.

The first conclusion that can be drawn from this study is that comment letters sent in an earlier stage of the standard setting process (discussion paper) are less biased by self-interest of firms than comment letters sent in a later stage (exposure draft). A possible explanation for this is that firms are not able to recognize the consequences of a new standard in an early stage of the standard setting process.

This study shows that firms with a bad solvency ratio and relatively much leases are more likely to comment negatively to the new lease standard. This is according to what was expected in the hypotheses; solvency ratio and the amount of leases were expected to be characteristics that would increase firms' interest in the new lease standard. Since both firms with a bad solvency and firms with relatively much leases would be affected negatively by the new standard, these firms were expected to comment negatively on the exposure draft.

The influence of having EBIT as KPI on comments given on the exposure draft is also tested in this paper. The results did not support the hypothesis. No significant evidence was found on the relationship between EBIT as KPI and the comment given on the exposure draft. This is according to literature though, because literature is not aligned with respect to the relationship between these two variables, which may explain why no significant results are found in the tests.

The results of this paper provide full support for the literature and hypotheses discussed above. Taking all evidence together, this paper suggests that firms are driven by their own interest in the participation process. This paper provides evidence that firms that are negatively influenced by the new lease standard, are much more likely to comment negatively on the

exposure draft than other firms. So self-interest is an important driver of the comment sent to the standard setter. This is quite a notable conclusion, since the standard setters assume that the comments received are prepared based on public interest and also treat them this way.

The size of the sample used in this study may be seen as a limitation. The sample only includes comment letters sent on one proposal. From these comment letters only a small part is used, because only the letters sent by preparers were considered to be useful. Another limitation has to do with the measurement of the variables SOLV and LEASE. These variables are transformed into dummy variables with values 1 and 0. The assigning of values 1 and 0 is based on the actual values of the variables. The boundaries that are set to determine which value has to be assigned to every variable are chosen in a not too convincing way. These boundaries are not based on previous research, but on an estimation and the reasoning of the author.

Future research may perform the similar research, but use a bigger sample, consisting of more than one accounting proposal. However to do this some specific characteristics of those other standards need to be identified first in order to identify possible determinants of self-interest on that specific standard. Another research continuing on this paper may use a similar model, but measure the variables on a continuous base.

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