FINANCIAL CRISIS AND LEGITIMACY OF GLOBAL ACCOUNTING STANDARDS

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ABSTRACT

Purpose: to examine and clarify a mechanism of global accounting standard-setting and accounting regulation, especially to investigate the legitimation crises of global accounting standards and their restoration process focusing on the IASB's response to the financial crisis.

Methodology: institutional theory and an analytical framework of **'**decoupling, compromises, and systematic dominance'

Findings: We find that the IASB decoupled its regular due process in order to maintain the endorsement mechanisms in the EU and avoid a further carve-out. To reconcile the concerns about the IASB's governance from the U.S. and the outside of Europe, the IASB established the monitoring board with compromising its expertise principle laying weight on independence with the request for enhancing its accountability. We also find that the IASB systematically put a dominance position to the needs of the EU as the biggest customer.

Originality/value: We show the complicated mechanism of accounting standard-setting which the mere debates of the politicization of accounting could not reveal, and clarify that the legitimacy of organization, procedure, and its outputs could not exist stand-alone, but mutually prerequisite or exist with reflexivity. This study extends our knowledge of global financial regulations and our discussion offers numerous suggestions to globalization, especially the IASB's roles in the globalization of financial regulations, and regulatory forum or network centered on the IASB.

Keywords: fair value accounting, financial crisis, global accounting standards, legitimacy, reflexivity

JEL classification: G01, M40, M41, M48

1. INTRODUCTION

The financial crisis arising from securitization of subprime loans has occurred during 2007-2008 and financial institutions in the U.S. and Europe holding a lot of the subprime mortgaged-backed securities (MBSs) and collateralized debt obligation (CDOs) reported huge losses, and then credit crunch began to progress. During the crisis, as the IASB permitted reclassification of financial assets bowing to political pressures from the EU, many were concerned about the IASB's governance. In these circumstances, we witnessed two 'legitimation crises' (Habermas, 1976) in global accounting standard-setting: the possible EU's another carve-out and the possible loss of the support from the biggest customer; and the possible loss of market confidence to the IASB and IFRS. However, the IASB has been still in the center of global convergence of accounting standards after the financial crisis. In other words, the financial crisis has made global convergence of accounting standards more compelling than before (Mala and Chand, 2012). In spite of two legitimation crises, why has the IASB promoted the global convergence of accounting standards more aggressively after the global economic turmoil? And, how has the IASB preserved and ensured its status as global accounting standard-setter in spite of crises of its legitimacy?

The purpose of this study is to examine and clarify a legitimation mechanism of global accounting standard-setting and accounting regulation exposed by politicization of accounting.[1] Especially, we investigate recent legitimation crises of global accounting standard-setting and their restoration process focusing on the IASB's response to the financial crisis.

To analyze that the IASB succeeds enhancing its public accountability and acceptance in global regulatory field, it is necessary to consider both accounting standard-setter and its accounting standards simultaneously. However, most studies only examined issues in either accounting standard-setter or accounting standards. On one hand, focusing on accounting standard-setter, the financial crisis revealed

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[1] The politicization of accounting generally means "accounting standard-setting becomes a forum on conflict of interests" (Oishi, 2000, p. 69). Although many studies examine this topic (e.g., Solomons, 1978; Solomons, 1983; Watts and Zimmerman, 1986; Hopwood, 1994; Oishi, 2000; Takatera, 2002; Zeff, 2002; Armstrong and Jagolinzer, 2005; Whittington, 2005; Fleckner, 2008; Zimmermann et al., 2008), we can indicate two common assumptions in these studies such as: (1) accounting information is originally political because it functions as a criterion of division of profits among stakeholders and has a great impact on their economic activities; (2) accounting standards are set through struggle among interested party. In this regards, as accounting is political "fundamentally with a double meaning" (Oishi, 2000, p. 33), in order to understand the politicization of accounting in a deeper way, we need to separate, on one hand, accounting standards becoming a political issue; on the other hand, incorporating politics into accounting standard-setting.

the issues in the IASB's governance and many previous studies analyzed these issues (Bengtsson, 2011; Nölke, 2011; Burlaud and Colasse, 2011; Botzem, 2012; Danjou and Walton, 2012). On the other hand, focusing on accounting standards, the financial crisis has also lead to heated debates on fair value accounting that is one of the main characteristic of IFRS (Hopwood, 2009; Laux and Leuz, 2009; Magnan, 2009),[2] and many previous studies investigated the relationship between fair value accounting and procyclicality (Shaffer, 2010; Bhat et al., 2011; Badertscher et al., 2012; Merrill et al., 2012).[3] However, to the best of our knowledge, few studies investigate how the relationship between organizations (accounting standard-setter) and their outputs (accounting standards) and how this relationship ensures the legitimacy of global accounting standard setting. Accordingly, this study will fill the gap in previous studies.

Applying institutional theory, we use the legitimacy model (Sanada, 2012) and an analytical framework of 'decoupling, compromises, and systematic dominance' (Tamm Hallström, 2004) to investigate the relationship between the legitimacy of the IASB and that of IFRS. Our findings show that the IASB tried to maintain the mechanisms of the endorsement from the EU, in other words, it tried to maintain the legitimacy element of '*taking advantage of the power of other organizations*' with decoupling the legitimacy element of '*theoretical consistency*' and '*justification through due process*' in order to avoid a further carve-out. In order to reconcile the concerns from the U.S. and the outside of Europe about the IASB's decision to bypass its usual due process, the IASB tried to maintain and restore its legitimacy by establishing the Monitoring Board, with compromising two elements of '*justification through organizational structure*' and '*superior organizations' delegation and/or acceptance of standard-setting activity*.' We also find that the IASB always had made it a priority to the element of '*justification through organizational structure*' based on the needs of the biggest customer of the EU.

This study makes several contributions. First, the primary contribution of this study is to the

[2] There are two opposing views on the relationship between fair value accounting and the financial crisis. One is that fair value accounting played a substantial role in the financial crisis. It is criticized as having triggered a liquidity death spiral and is blamed for the crisis (American Bankers Association, 2008; Wallison, 2008). The other is that fair value accounting did not play a substantial role in the financial crisis (Ryan, 2008a; SEC, 2008; Laux and Leuz, 2010; Barth and Landsman, 2010; Laux, 2012). Regardless of the accounting system, fair value (market price) is only linked to capital regulations and private contracts, and thus fair value accounting does not cause the financial crisis (Ball, 2008; Véron, 2008).

[3] Analytical research demonstrates that fair value accounting contributes to procyclicality (Cifuentes et al., 2005; Allen and Carletti, 2008; Plantin et al., 2008; Novoa et al., 2009; Heaton et al., 2010; Eboli, 2010; Kusano, 2012).

accounting literature. Especially, with using an analytical framework of 'decoupling, compromises, and systematic dominance,' this study shows the complicated legitimation mechanism of accounting standard-setting which the mere debates of the politicization of accounting could not reveal. Second, this study contributes to discussions about the legitimacy of organizations and institutions. In particular, our analysis indicates the legitimacy of organization, procedure, and its outputs could not exist stand-alone, but mutually prerequisite or exist with 'reflexivity' (Giddens, 1984). Lastly, this study extends our knowledge of global financial regulations and our discussion offers numerous suggestions to globalization, especially the IASB's roles in the globalization of financial regulations, and regulatory forum or network centered on the IASB.

The remainder of this paper proceeds as follows. The second section clarifies our methodology and analytical framework. In the third and fourth sections, we investigate and discuss the IASB's response to the financial crisis using this framework. The final section provides concluding remarks and remaining issues.

2. METHODOLOGY

Based on institutional theory, especially focusing on organizational legitimacy, this study analyses the interactions, which construct the legitimacy of global accounting standard-setting, between global accounting standard-setter and its standards. In other words, this is an historical analysis of a recursive relation between the legitimacy of organization and the legitimacy of its outputs.

2.1. Institutional theory

What makes organizations more or less similar to each other is a longstanding question in organizational theory (Boxenbaum and Jonsson, 2008). On one hand, functional theory of organization, assuming efficiency-seeking organizations, explained that organizations in the same environments took on similar forms in order to seek the optimal fit with their environment and adapt to technical pressures; on the other hand, institutional theory insisted that organizations adapted not only to technical pressures but also to societal expectation to them, and explained these phenomena as institutional isomorphism. A central idea of institutional isomorphism is organizational conformity to 'rationalized myths' (Meyer and

Rowan, 1977) in society about what constitute a proper organization or legitimate organization, and it is facilitated by the diffusion of ideas, practices and prescribed organizational structure among organizations (DiMaggio and Powell, 1983).

Institutional theory outlined three institutional pressures that impose organizational similarity: coercive, mimetic, and normative pressures (DiMaggio and Powell, 1983). Coercive pressures come from power relation and politics. For instance, the state demands to adopt specific organizational structures, practices, or rules. Mimetic pressures arise from uncertainty. When organizational technologies, goals, and environment are uncertain, organizations make themselves similar to other organizations. Normative pressures are related to professionalization. Professionalization initiates formal education, legitimation in a cognitive base, and the growth and elaboration of professional network; and professions tend to have the same value of legitimacy and tend to adopt similar organizational structures and practices. When organizations face these pressures to adapt societal expectation to what organizations should look like and do, there have been two problems: adapting to societal expectation or institutional myths may not comprise an efficient solution for organizations; and there are competing and internally inconsistent rationalized myths may exist simultaneously. In these cases, organizations decouple their practices from their formal structure in order to gain or maintain their legitimacy (Meyer and Rowan, 1977).

Both technical efficiency and conformity to institutional myths can be precursors of legitimacy (Meyer and Rowan, 1977). Legitimacy studies also categorize three types of organizational legitimacy: pragmatic legitimacy, moral legitimacy (or professional legitimacy), and cognitive legitimacy (Suchman, 1995). Pragmatic legitimacy is corresponding to technical pressures and based on the self-interested calculations of an organization’s most immediate audiences. For instance, such discourse of pragmatic legitimacy are claimed: adopting a single set of high-quality accounting standards such as IFRS would enhance the quality and comparability of financial reporting; and/or the IASB has ability to set a high-quality accounting standards. Moral legitimacy or professional legitimacy reflects a positive normative evaluation of the organization and its activities and is corresponding to normative pressures. If professional groups as gate keepers (regulatory bodies, accountancy professions, financial analysts, and investors) endorse IFRS as acceptable accounting standards in their respective jurisdictions, compliance to IFRS would be mandatory and the endorsement means a delegation of accounting standard-setting to the IASB as a private sector. Cognitive legitimacy involves either affirmative backing for an organization or mere acceptance of the organization as necessary or inevitable based on some taken-for-granted cultural account. In the absence of the alternative standard-setters and due to the further diffusion, IFRS would be recognized as taken-for-granted accounting standards. At the same time, IFRS adoption of national regulatory bodies would make further expansion of the firms that prepare their financial statements in accordance with IFRS. In the further diffusion of IFRS, organizations and regulatory bodies would feel mimetic pressures arising from uncertainty of their future prospects.

2.2. Legitimacy of global accounting standard setting

2.2.1. Definition of legitimacy

This study assumes the global diffusion of IFRS as an institutionalization of IFRS or the process in which IFRS gains legitimacy in the global financial field. For diffusion studies, there has been little empirical research with institutional isomorphism as the outcome of diffusion; on the other hand, there are a lot of empirical studies with isomorphism as the cause of diffusion (Boxenbaum and Jonsson, 2008). Focusing on global accounting standards such as IFRS, the global diffusion of IFRS is different from other standardization by international private sector organizations, since mandatory IFRS adoption automatically means that it would become statutory accounting rules and/or institutional norms in the respective jurisdiction; we can assume that the diffusion of IFRS (the adoption of IFRS) simultaneously constitutes an institutionalization of IFRS.

The IASB as a global accounting standard-setter is a subject of legitimation from legitimacy granted authorities such as G20, IOSCO, SEC, and other regulatory bodies. At the same time, the IASB is also a source of legitimacy (especially, professional legitimacy) as a legitimacy granted authority to its own standards, as such Deephouse and Suchman (2008) indicated that “many common source of legitimacy are themselves organization” (Deephouse and Suchman, 2008, p. 56). On the other hand, IFRS as a set of accounting standards with possessing pragmatic legitimacy would assure cognitive legitimacy of the IASB. This kind of recursive relationship exists between the IASB and IFRS. A lot of studies discussed the legitimacy of accounting standards and accounting standard-setters (e.g., Johnson and Solomons, 1984; Wallace, 1990; AAA's FASC, 1999; Larson, 2002; Schmidt, 2002; Tamm Hallström, 2004; Black and Rouch, 2008; Zimmerman et al., 2008; Richardson, 2009; Burlaud and Colasse, 2011; Richardson and Eberlein, 2011; Danjou and Walton, 2012). In these studies, some pointed out common bases or components of the legitimacy of accounting standards (or accounting standard-setter), however, extant literature did not necessarily examine these components of the legitimacy constitutionally. To the best of our knowledge, there is no such study that separates the legitimacy of accounting standards and that of accounting standard-setter, although there are interesting recursive relations among them. Accordingly, this study will fill the gap in previous studies.

For the definition of legitimacy, although many studies refer to the following Suchman's definition, there still remains ambiguity of the meaning of legitimacy.[4]

> Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system[s] of norms, values, beliefs, and definitions (Suchman, 1995, p. 574).

Instead, this study proposes the pragmatic term in defining legitimacy from a propositional meaning (e.g. legitimacy is…) to a pragmatic meaning (e.g. legitimacy functions as…). When we think about how the legitimacy of the IASB and/or IFRS functions, we need to assume there are some stakeholders such as regulators, preparers, and users. For these stakeholders, we can easily imagine that legitimacy functions as a motivation for acceptance or compliance. In this regards, we define legitimacy as a motivation for acceptance among multi-stakeholders, and the legitimacy of global accounting standards means that of a global accounting regulatory system as an institution including IFRS as global accounting rules and the IASB as global accounting standard-setters. This kind of legitimacy is not uniquely-determined by tradition, charisma, or rationality, but demands a multi-strata mechanism or procedure in order to reach an acceptance among stakeholders. This legitimacy also assumes the modern regulatory network constituted by a multilayered network. This network refers to a relationship among standard-setting activities (or standard-setters) and such activities as promotions, interpretations, introductions,

[4] Suchman himself cautions that "many researchers employ the term legitimacy, but few define it. Further, most treatments cover only a limited aspect of the phenomenon as a whole" (Suchman, 1995, p. 572). He also discusses organizational strategies for gaining legitimacy, maintaining legitimacy, and repairing legitimacy. In other words, he assumes that legitimacy could be gain, maintain, and repair strategically. In this regard, we share his consideration and discuss strategic properties of the legitimacy of global accounting standard-setting.

implementations, etc. (or organizations performing these activities). As networks among organizations are defined as 'a repeated exchange based upon the organizations supplementing each other and having different specializations' (Ahrne and Brunsson, 2008, p. 163), networks essentially assumes differences and a 'flat' relationship among its members. However, the network, in which reference organizations[5] are effective, includes authoritative relationships that postulate the hierarchy among organizations, which are different from other normal networks. From that point of view, we can assume that the accounting regulatory network centered on the IASC/IASB are the multilayered regulatory network instituted by authoritative relationships with reference organizations, inter-organizational network, and human network based on expertise.

2.2.2. Legitimacy model

The legitimacy model (Sanada, 2012) constitutionally analyzes the legitimacy of the global accounting regulatory system,[6] in which we can assume a multilayer network and separates two components of the legitimacy of the IASB and that of IFRS that have not necessarily been separated in previous studies. By employing the concept of reflexivity,[7] this model suggests the mechanism in which both the legitimacy of accounting standards and that of standard-setter interrelate with each other to construct the legitimacy of global accounting standards as a system.

Previous studies (e.g., Johnson and Solomons, 1984; Richardson, 2009; Burlaud and Colasse, 2011; Richardson and Eberlein, 2011), consider the legitimacy of standard-setting as a three-stage process:

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[5] Reference organizations refer to organizations that were generally accepted as being important and authoritative in the environment in which network activities were operated (Tamm Hallström, 2004, p. 152). For the IASB, the EU, SEC and G20 role and function as reference organizations.

[6] The legitimacy model is based on Tamm Hallström's four strategies to achieve compliance with standards: 1) public statements about the benefits of compliance; 2) strengthening authority through organizing principles; 3) strengthening authority through cooperation with reference organizations; and 4) taking advantage of the power of others (Tamm Hallström, 2004); and also aforementioned Suchman' s three types of organizational legitimacy: 1) pragmatic legitimacy; 2) moral or professional legitimacy; and 3) cognitive legitimacy (Suchman, 1995).

[7] Giddens (1984) explains social practices and the constitution of society with using the concept of reflexivity. He suggests that continuity of practices presumes reflexivity, but this reflexivity is in turn possible only because of the continuity of practices that makes them distinctive the same across space and time; hence, reflexivity should be understood not merely as self-consciousness, but as the monitored character of ongoing flow of social life (Giddens, 1984, p. 3). With introducing these concepts of 'reflexive monitoring of action' and 'reflexive self regulation', he suggests causal loops which have "a feedback effect in system reproduction, where that feedback is substantially influenced by knowledge which agents have of the mechanisms of system reproduction and employ to control it" (Giddens, 1984, p. 376).

input, procedure or through-put, and output. However, as the due process, which is referred to procedural legitimacy, is connected with and affects both input legitimacy and output legitimacy, this trichotomy could not necessarily explain mutual interactions between the legitimacy of the IASB and that of IFRS. Meanwhile, the legitmacy model disaggregates both of the legitimacy of the IASB and that of IFRS into elements. As the elements of the legitimacy of the IASB, it suggests (1) *justification through organizational structure and due process*, and (2) *superior organizations' delegation and/or acceptance of standard-setting activity*. And as the elements of the legitimacy of IFRS, it suggests (1) *justification through benefits brought from application of IFRS*, (2) *taking advantage of the power of other organizations*, (3) *providing decision-useful information*, (4) *theoretical consistency*, and (5) *consistency among other institutions*. The legitimacy model also suggests not only each element constructs the legitimacy of the IASB and that of IFRS, but also those elements interrelate with each other and construct the legitimacy of global accounting standards as an institution.

For instance, in the legitimacy model, we assume that satisfying user needs and due process corresponds to '*justification through organizational structure and due process*' of an element of the legitimacy of the IASB.[8] However, both the principle of user needs that accounting standards are set based on the needs of users of financial statements and the due process that accounting standard-setting includes the process in which stakeholders opinions are reflected, fulfill a critical role to achieve '*taking advantage of the power of other organizations,*' therefore the principle of user needs and the due process also interrelate the legitimacy of IFRS. In a similar way, '*superior organizations' delegation and/or acceptance of standard-setting activity'* of an element of the IASB's legitimacy and '*taking advantage of the power of other organizations'* of an element of IFRS's legitimacy interrelate with each other in reality, and also play the same role to construct the legitimacy of global accounting standards as a system. More specifically, the IASB as a private-sector accounting standard-setter gets the approval of its standard-setting activities from the EU and IOSCO, and in this way the IASB applies a public coercive power to its standards (IFRS) and to appear IFRS as official standards, and then the IASB tries to increase compliance with standards (Tamm Hallström, 2004, p. 152).

[8] The legitimacy model assumes that organizing standard-setters based on the organizing principles is important for the legitimacy of the IASB (Sanada, 2012). For the due process, refer to Richardson and Eberlein (2011).

As observed above, the legitimacy model, by introducing the concept of reflexivity, shows a mechanism in which both the legitimacy of accounting standards and that of standard-setter interact with each other to construct the legitimacy of global accounting standards as an institution (See Figure 1).

[Insert Figure 1]

2.3. Decoupling, Compromises, and Systematic Dominance

The legitimacy elements of the IASB and IFRS each construct the legitimacy of the IASB and that of IFRS, but they also mutual interrelates with each other. In that sense, on one hand, there are mutually complementary relationships; on the other hand, sometimes there are tensions with each element. With investigating these tensions, we can transform a simple static conceptual model into a dynamic model. This study uses a 'decoupling, compromises, and systematic dominance' framework to examine such tensions.

In the discussion about organizing principles for global standard-setter, Tamm Hallström (2004) presents the model of four organizing principles such as the principle of expertise, the principle of representativeness, the principle of user needs, and the principle of financiers.[9] She suggests that these principles are mutually related and sometimes bear tensions such as collisions and inconsistency, and points out these tensions are managed by decoupling, compromises, and systematic dominance (Tamm Hallström, 2004, pp.163-167).

2.2.1. Decoupling

Decoupling means allowing different principles to dominate depending upon the situation or phase in focus. The most important concept of institutional theory is organizational isomorphism. Organizational isomorphism is "a constraining process that forces one unit in a population to resemble other units that

[9] The principle of expertise assumes that the experts were given the legitimacy to decide what standards were needed and how those standards should be formulated, and the basis for their decisions was expert knowledge. The principle of representativeness assumes the importance of several interest groups being represented and thus given the opportunity to influence and participate in the standardization work. The principle of user needs means that the needs of the users should be the basis for what is standardized and how the standards are shaped. The principle of financiers assumes that the interest of financiers becomes a part of the organizing work (Tamm Hallström, 2004, pp. 141-151).

face the same set of environmental conditions" (DiMaggio and Powell, 1983, p. 149). In the discussion of this process, the concept of decoupling is presented. Meyer and Rowan (1977) point out that the principle elements of organizational structure are decoupled from activities and from each other at the legitimacy crisis of organization (Meyer and Rowan, 1977, p. 357). Here, it is assumed the inconsistencies and anomalies between the principles prescribing inside formal structures and the principle prescribing outside technical activities. Therefore, decoupling these principles enables organizations to maintain formal structures while their activities vary in response to practical considerations.

2.2.2. Compromises

Compromises mean to resolve the problems by modifying principles or developing compromise solutions between principles, while tensions are existed between organizing principles. This concept is also presented in the discussion of organizational isomorphism. Paradis and Cummings (1986) assess the development of hospice in the U.S. with using a theory of organizational isomorphism. They especially suggest that in coercive isomorphism process "government does not simply impose its standards on newly designed social service entities. A process of negotiation and compromise occurs as bureaucrats and advocates try to hammer out a solution" (Paradis and Cummings, 1986, p. 380). Carpenter and Feroz (2001) also use the concept of organizational isomorphism to explore the implementation process of generally accepted accounting principles (GAAP) by four state governments in the U.S., and identify 'compromise' as an initial strategic response to institutional pressures to adopt GAAP by the state governments.

2.2.3. Systematic dominance

Systematic dominance means to systematically allow one principle to dominate over another principle, while tensions are existed between organizing principles. Tamm Hallström (2004) identifies the principle of expertise was in the dominant position in many of the IASC's activities, and thus caused tensions in relation to other principles (Tamm Hallström, 2004, p. 166). While tensions among organizing principles were resolved by some decoupling and compromises, the principle of expertise systematically dominated over the other. Therefore, when the IASC faced the problem to maintain expert integrity at the same time confronting with demands of increased speed and efficiency, the principles of expertise were the most important and should dominate.

These concepts, however, are not always used independently to resolve tensions among conflicting organizing principles. For instance, while one principle is decoupled at a certain phase, the other principle dominates or compromise solutions are developed at another phase. While a certain principle systematically dominates at every circumstance, the other principle as exception may be adopted through decoupling. This study uses these three concepts as a framework to examine the relationship between each element of the legitimacy model.

3. IASB'S RESPONSE TO THE FINANCIAL CRISIS

In the following sections, focusing on the IASB's response to the financial crisis in two levels: accounting standards and organization, we examine the legitimacy of global accounting standards as institution with the legitimacy model and decoupling, compromises, and systematic dominance framework. During the financial crisis, the legitimacy of the IASB was significantly damaged by issuing the accounting standard that permits the reclassification of financial assets. Nevertheless, the IASB has been still in the center of global convergence of accounting standards. Through investigating this legitimation crisis of global accounting standard-setting we identify the process of preservation and restoration of the legitimacy of the IASB and IFRS.

3.1. EU political commitment

In July 2002, the EU issued the IAS Regulation in which required the EU listed companies to apply IAS/IFRS for the consolidated accounts from 1 January 2005 (Regulation (EC) No. 1606/2002). However, the EU does not automatically accept the standards, but decides its acceptance through the endorsement process to each accounting standard. In fact, the European Committee (EC) experienced "the strong political commitment" (Enria et al., 2004, p. 7) in the endorsement process of IAS 39, *Financial Instruments: Recognition and Measurement*.

Banking regulatory and supervisory bodies such as the Basel Committee and the European Central Bank especially concerned about the effects of the expansion of fair value accounting for financial instruments in the view of the financial stability (procyclicality) and opposed to its expansion (e.g., BIS, 2001; ECB, 2001; ECB, 2004; Enria *et al.*, 2004; ECB, 2006). Because of their oppositions, the EC carved out the fair value option and the macro hedging as "a short-term solution" (Brackney and Witmer, 2005, p. 26) in order to endorse IAS 39. Continuing the revision of IAS 39, the IASB issued amendment to IAS 39, *The Fair Value Option*, in which stating the fair value option could be applied only in specific circumstances, then the EC finally endorsed this standard in November 2005. However, there still remains a carve-out under the EU endorsement process in respect of the macro hedging. In these circumstances, prior studies suggest that "the endorsement process of the EU is the biggest threats to the IASB's independence" (Fleckner, 2008, p. 301)[10] and "the governance network of the IASB is much more strongly connected to financial sector actors" (Perry and Nölk, 2005, p. 17).

3.2. The IASB's response

The increases of interest rates and the declines of house sales prices in the U.S. brought high default rates on subprime mortgages, and the subprime mortgage banks stopped the subprime mortgage securitizations and faced a greater risk of bankruptcy. Then, in July 2007, rating agencies lowered the credit rating of the subprime MBSs. After that, financial institutions in the U.S. and Europe holding a lot of the subprime MBSs and CDOs which securitized the subprime MBSs, reported huge losses and credit crunch began to progress (e.g. FSF, 2008a, pp. 5-6; Ryan, 2008b, pp. 1618-1623). Additionally, after the bankruptcy of Bear Steams and Lehman Brothers in 2008, the subprime mortgage crisis spread into the global financial crisis. In this regards, fair value of financial instruments held by financial institutions could make huge losses and lead to the crisis in the financial system. The financial crisis has lead to heated debates on the pros and cons of fair value accounting (Hopwood, 2009; Laux and Leuz, 2009; Magnan, 2009).

[10] Fleckner (2008) also suggests that "the endorsement process does create opportunities to influence the Board, and although this kind of influence is primarily political, it establishes a forum for complaints not only for governmental agencies but also, through normal lobbying, for the users of the standards such as accountants and issuers" (Fleckner, 2008, p. 301).

3.2.1. Reclassification of financial assets

In the progress of the financial crisis, the EU expressed their concerns about IAS 39 and demanded the IASB to revise it. For instance, the Economic and Financial Affairs Council (ECOFIN) announced the following decision on 7 October 2008.[11]

> We take note of the flexibility in the application of mark to market valuation under IFRS as outlined in recent guidance from the IASB. Ecofin strongly recommends that supervisors and auditors in the EU apply this new guidance immediately. We also consider that the issue of asset reclassification must be resolved quickly. To this end, we urge the IASB and the FASB to work together on this issue and welcome the readiness of the Commission to bring forward appropriate measures as soon as possible (ECOFIN, 2008, p. 8).

The EU Commissioner for Internal Market and Services C. McCreevy, in the European Parliament Plenary Session on 8 October 2008, declared that they were ready to accept such accounting rule which would provide the same flexibility that was offered to banks in the U.S. if banks in the EU wanted to move assets from their trading books to their banking books (McCreevy, 2008, p. 2). In other words, McCreevy made threats that "he had legislation prepared to have a 'carve out' from part of our standards" (House of Commons, 2008, Q186, statement by Sir David Tweedie), if the IASB rejected the option that approved reclassification of financial assets from a category of fair value measurement to a category of amortized cost or historical cost measurement.

Since many people, including Sir David Tweedie, believed that "a second European carve out would lead to the demise of the worldwide globalisation project" (André et al., 2009, p. 14), the IASB discussed about reclassification of financial assets at the Board meeting on 13 October 2008, and issued amendments to IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Instruments: Disclosure*, that would permit reclassification of some financial instruments, without

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[11] European G8 members (especially, France, Germany, Italy, and the UK) also issued the following statements on 4 October 2008.

> We will ensure that European financial institutions are not disadvantaged vis-à-vis their international competitors in terms of accounting rules and of their interpretation. In this regard, European financial institutions should be given the same rules to reclassify financial instruments from the trading book to the banking book including those already held or issued. We urge the IASB and the FASB to work quickly together on this issue in accordance with their recent announcement. We also welcome the readiness of the Commission to bring forward appropriate measures as soon as possible. This issue must be resolved by the end of the month (European G8 Members, 2008, par. 9).

following the regular due process.[12] With this standards, if financial assets were no longer held for the purpose of selling or repurchasing them in the near term (IASB, 2008c, par. 50(c)), the reclassification of some financial instruments out of the fair value through profit or loss category and out of the other category would be approved (IASB, 2008c, par. 50). More specifically, only in rare circumstances,[13] an entity would be approved to reclassify financial assets of the fair value through profit or loss category into the available-for-sale category or the held to maturity category (IASB, 2008c, pars. 50B-50C). In addition, if financial assets would have met the definition of loans and receivables, and if the entity had the intention and ability to hold the financial assets for the foreseeable future or until maturity; financial assets may be reclassified out of the fair value through profit or loss category to the loans and receivables category (IASB, 2008c, par. 50D).

The IASB approved the reclassification of financial assets upon the satisfaction of certain conditions in order to avert the further EU carve-out. In the result, financial institutions could avoid the application of fair value accounting with exerting 'reclassification option' with which reclassified financial assets from the trading book to the banking book.[14] Although "the IASB is determined not to be swayed by sheer political pressure" (Whittington, 2005, p. 151), the IASB bowed to political pressure from the EU again in a deterioration of the financial crisis.

3.2.2. Governance reform of the IASB (or IASCF)

With issuing amendments to IAS 39, the IASB could avoid another EU carve-out. However, it caused concerns about the IASB's governance because it skipped out on its regular due process.

In these circumstances, at the 2008 G20 Washington Summit on Financial Markets and the World Economy (the G20 Washington summit) in November 2008, it contained accounting issues in the declaration and Action Plan. Especially, the immediate actions for strengthening transparency and accountability by March 31, 2009 included: 1) to enhance guidance for valuation of securities during

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[12] In this process, the IASB not only put aside its normal due process, but also permitted reclassifications retroactively back to June 2008, before prices on loan and debt instruments had fallen substantially, because the political pressure from the EU was so intense (Bushman and Landsman, 2010, p. 269).

[13] The IASB indicates that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term (IASB, 2008c, par. BC104D).

[14] Kholmy and Ernstberger (2010), Fiechter (2011), Bischof et al. (2011), and Paananen et al. (2012) empirically examine the impact of reclassification option of financial assets on financial institutions.

times of stress; 2) to address weakness in accounting and disclosure standards for off-balance sheet vehicles; 3) to enhance the required disclosure of complex financial instruments; and 4) to enhance the governance of the international accounting standard-setting body.

> With a view toward promoting financial stability, the governance of the international accounting standard-setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities (G20, 2008).

The first three immediate actions were adhered the proposals in the report of the Financial Stability Forum (FSF).[15] However, the governance reform engaged with the movement by the IASC Foundation (IASCF) that then had been laying the revision of the Constitution.[16] The IASCF revised its Constitution every five years and the last revision was in 2005. As the EU was failed to increase its influence in the IASB at the first constitutional review, they tried to do it again with increasing its weight in the governance of the IASB (Bengtsson, 2011, pp. 574-577). The EU issued the report and suggested the problems of the IASB/IASCF governance structure.

> Public interest (including financial stability) aspects are currently not reflected in the governance structure or in the due process of the IASB. [……] As the importance of the IASB as an international accounting standard-setter increases, and in particular where the standards it adopts are endorsed by law and are mandatory, it is crucial that these aspects are included in future discussions of the objectives of IASB and IASCF (EC, 2007a, p. 4).

Furthermore, in July 2007, the EC issued the report and raised the same issue in the IASB/IASCF governance structure (EC, 2007b). Responding to these proposals from the EU, the IASB (or the IASCF) issued a press release in which indicated to establish “a link to a representative group of official organisations, including securities regulators” as the first step of the constitutional revision on November 6, 2007 (IASCF, 2007). With this press release, the EC, the Financial Services Agency of Japan (JFSA), the IOSCO, and the U.S. SEC immediately proposed to establish a new monitoring body within the governance structure of the IASC Foundation on November 7, 2007 (SEC, 2007). Furthermore, in

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[15] The Financial Stability Forum (FSF) was founded in 1999 to promote international financial stability in the discussion among Finance Ministers and Central Bank Governors of the G7 countries, and initial members included the IASB. The 2009 G20 London summit decided to establish the Financial Stability Board (FSB), as a successor to the FSF. The FSF issued the reports in April 2008 (FSF, 2008a) and October 2008 (FSF, 2008b) to recommend the IASB to improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work other standard setters toward international convergence.

[16] The International Accounting Standards Committee Foundation (IASCF) was the former name, and by the revision of the Constitution it was changed to the IFRS Foundation from March 1, 2010.

February 2008, the European Parliament's Committee on Economic and Monetary Affairs published the report and required to set up a public oversight body of the IASB/IASCF to improve the governance and the accountability of the IASB (European Parliament, 2008, par. 8).

In this manner, the reform of the governance had been discussed before the financial crisis. In July 2008, the IASCF published a discussion document and proposed to establish a Monitoring Group that creates a link with representatives of public authorities and international organizations (IASCF, 2008, p. 4). During the crisis, the IASB, responding to request for the governance reform from G20, announced the establishment of the Monitoring Board in January 2009 (IASCF, 2009a) and issued the revised constitution in February.[17] The establishment of the Monitoring Board meant an enhancement of public accountability while the IASB maintained its independency in accounting standard-setting process (IASCF, 2008, par. 17; IASCF, 2009a), and the Board were, initially, comprised with the responsible member the EC, the chair of the IOSCO emerging Markets and Technical Committees, the commissioner of the JFSA, and the chairman of the SEC. The chairman of the Basel Committee on Banking Supervision (BCBS) also participated as an observer (IASCF, 2009b, par. 21). The concrete roles of the Board were to appoint and approve the Trustees and to review and provide advice to the Trustees regarding the IASB accounting standard-setting processes (IASCF, 2009b, par. 19).

As mentioned above, the IASB issued amendments to IAS 39 without its regular due process, thus caused concerns about its governance. Although the governance reform had been proceeding in the discussion of the constitutional revision, an enhancement of the governance of the IASB was included in the G20 immediate actions. Therefore, responding to this requirement, the IASB/IASCF established the Monitoring Board to enhance its public accountability. In the G20 Declaration, the IASB was regarded as the international accounting bodies that set "a single set of high-quality global accounting standards" (e.g., G20, 2009a; G20, 2009b) and became a center of global convergence of accounting standards.

[17] For the constitutional revision in February 2009, the IASB/IASCF not only established the Monitoring Board, but also increased their membership form 14 to 16 and included provisions of their geographical representation (IASCF, 2009b, pars. 24-26). The IASB's decision to emphasize the members' geographical representation was explained to enhance "the legitimacy of the IASB" (IASCF, 2008, par. 8). However, the impact of this change of the IASB's institutional logics to its legitimacy would be another important research challenge in the future.

4. DISCUSSION AND THEORETICAL IMPLICATIONS

4.1. Discussion

Regarding the IASB's response to the financial crisis with the legitimacy model, we find tensions among elements of the legitimacy of the IASB and that of IFRS. More concretely, we find tensions between the political pressure from the EU as the main client of IFRS, in other words, '*justification through organizational structure'* based on user needs principle and '*justification through due process*'; the tension between '*taking advantage of the power of other organizations*' and '*theoretical consistency*.' In this section, we further investigate these tensions with the analytical framework of 'decoupling, compromises, and systematic dominance.'

4.1.1. Decoupling

The IASB faced the political pressure from the EU to accept reclassification of financial assets, and the IASB was eager to fight back the another curve-out of certain provisions of IAS 39 by the EU which might turn back the clock oriented to the global acceptance of IFRS (Yamada et al., 2009, p. 92, remarks by Yamada). Therefore, the IASB issued amendments to IAS 39, *Reclassification of Financial Assets*, as "a tentative solution" (Yamada et al., 2009, p. 91, remarks by Yamada) that would permit reclassification of financial assets only in rare circumstances.

The IASB, then, had been revising IAS 39 with the aim of the expansion of fair value accounting for financial instruments, and suggested fair value seems to be the only measurement basis that is appropriate for all types of financial instruments (IASB, 2008a, pars. 3.7-3.39) in Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, in March 2008. On one hand, the IASB prioritize fair value measurement of financial assets; on the other hand, the IASB permitted reclassification of financial assets and made European banks possible to change the measurement basis from fair value to historical cost or amortized cost. Thus, we can assume the IASB decoupled 'theoretical consistency' of their emphasis to fair value measurement only in rare circumstances with reclassification of financial assets.

Furthermore, although the IASB develops an accounting standard, publication of an exposure draft is a mandatory step in its due process (IASCF, 2006, par. 38) and a comment period needs no less than 30 days even if the matter is exceptionally urgent (IASCF, 2006, par. 40), the IASB issued amendments to IAS 39 that would permit reclassification of financial assets without following the regular due process. Due process is the one of the important requirements for the legitimacy of the IASB as a private sector accounting standard-setter (e.g., Johnson and Solomons, 1984; AAA's FASC, 1999; Zimmerman et al., 2008; Sanada, 2012). However, Gerrit Zalm, Chairman of the Trustees of the IASCF, stated the Trustees' unanimous position as follows;

> The Trustees, as the IASB's oversight body, recognise, as does the IASB, the urgency of the situation facing the world's financial markets. We support the IASB in suspending the normal due process to take action in these present extraordinary circumstances (IASB, 2008b, p. 2).

With the recognition and supports from the Trustees, the IASB omitted its regular due process and permitted reclassification of financial assets. We assume the IASB decoupled 'justification through due process' as the important principle for its legitmacy.

4.1.2. Compromises

The IASB/ IASCF established the Monitoring Board as part of the governance reform responding to the G20 requirement and as one consequence of the constitutional revision. The IASB previously only had accountability to the IASCF Trusties; the establishment of the Monitoring Board enhanced its public accountability, especially to such reference organizations as financial regulators and enabled the IASB to include public authorities (reference organizations) directly into the multilayered regulatory network centered on the IASB much more than before in the form of the Monitoring Board.

The purpose of the Monitoring Board was explained as an enhancement of public accountability while the IASB maintained its independency in accounting standard-setting process. However, accountability and independency of organization originally have a tension between them. Indeed, a small minority of people opposed to the creation of the Monitoring Board, "because of concerns regarding political interference in the standard-setting process" (IASCF, 2009c, par. 18). In addition, some interested parties were concerned that the Monitoring Board nominates Trustee because "this could politicize the organization and the IASB's agenda" (IASCF, 2009c, par. 31). Therefore, we assume that the IASB's response as compromise between '*justification through organizational structure and due process*' based on expertise principle laying weight on independence and '*superior* *organizations' delegation and/or acceptance of standard-setting activity*,' in other words, compromise among elements of the legitimacy of accounting standard-setter.

4.1.3. Systematic dominance

The IASB's acceptance of reclassification of financial assets that had been prohibited provided benefits to European financial institutions and firms because this reclassification ensured they were not disadvantaged vis-à-vis their US competitors (in fact, however, this benefit was not for global firms but only for European firms, especially for financial institutions). This means the IASB's amendments of accounting standards was the response to the need of the EU/EC that is the biggest client and has a right to endorse IFRS, and we can assume that the IASB assigned the highest priority to the legitimacy element of '*justification through benefits brought from application of IFRS.*'

In the endorsement process of IAS/IFRS, the EU carved out provisions of the fair value option and the macro hedging in IAS 39. The main reason, especially, for the fair-value-option-carve-out was concerns expressed by the European Central Bank and national regulatory bodies about inappropriately uses of the fair value option. Also, financial sectors had the most significant influence to the governance of the IASB (Perry and Nölk, 2005), and the EU was the biggest threats to the IASB's independence. This might be suggested that the IASB had always made it a priority to the requirement of the EU as the biggest customer, or systematic dominance of '*justification through organizational structure*' or user needs. On the other hand, systematic dominance of user needs, by the reflexivity of the legitimacy, meant the continuation of the EU endorsement mechanism of IFRS, '*taking advantage of the power of other organizations'* and ensured the EU's '*delegation and/or acceptance of standard-setting activity.*'

4.2. Legitimation crisis

We could suggest two legitimation crises of the IASB and/or IFRS before and after the IASB issued amendments to IAS 39: the possible EU's another carve-out and the possible loss of the support from the biggest customer; the possible loss of market confidence to the IASB and IFRS for the people outside of the EU.

Before issuing the amendments of IAS 39 and IFRS 7, there was "a blunt threat to blow the organization away" (House of Common, 2008, Q. 186, statement by Sir David Tweedie) with the possibility of another carve-out from the EU to ensure EU banks be in a level playing field or not in a situation of disadvantage as compared to banks for other markets (Barroso, 2008, pp. 2-3).[18] This suggested not only a loss of '*superior organizations' delegation and/or acceptance*' to the IASB and '*the power of other organizations*' of a legitimacy element of IFRS, but possibilities of another carve-out in other jurisdictions.

After issuing amendments, the IASB's attitude with which changed the existing accounting standards without its regular due process bowing to political pressures from the EC, became "a focus of criticism" (Nishikawa, 2009, p. 11). Especially in the U.S., there had been a lot of opposition to political interventions to accounting standard-setting process,[19] Chairman of the SEC Mary L. Schapiro indicated concerns about "the independence of the International Accounting Standards Board and the ability to have oversight of their process for setting standards and the amount of rigor that exists in that process today" (statement at the U.S. Senate Committee on Banking, Housing, and Urban Affairs on 15 January 2009).[20] Also, the Financial Crisis Advisory Group (FCAG) of the IASB/FASB discussed the relationship between investor confidence and due process in its first meeting (FCAG, 2009, par. 44). These remarks suggested that these amendments without regular due process defamed '*justification through due process*' of a legitimacy element of the IASB, and this would impair the legitimacy of IFRS with effecting '*taking advantage of the power of other organizations*' or '*theoretical consistency*.' In corresponding to these crises, the IASB conducted the governance reform.

In a related action, the change of involvement to accounting standard-setting by national financial authoritative bodies was exposed in the financial crisis (Inoue et al., 2009). National financial authorities had been voicing their opinions through such international institutions as the IOSCO, the BCBS, or the International Association of Insurance Supervisor (IAIS). However, during the financial crisis, national

[18] For financial assets, there had been differences between IFRS and US GAAP in the following points: reclassification of the non-derivative financial asset held for trading category into the available-for-sale or held to maturity category in particular situations; reclassification of the non-derivative financial asset held for trading category into the loans and receivables category; and impairment accounting.

[19] For instance, the chairman of the Financial Accounting Foundation (FAF) Denham send letters to the Senate and the House of Representatives, and the key personalities in this matter in which he expressed concerns about the political involvement to legislate the suspension of SFAS 157, *Fair Value Measurements*.

[20] Refer to the following website: http://www.iasplus.com/pastnews/2009jan.htm#schapiro.

authoritative bodies participated in the discussion of accounting standard matters relating to the financial stability in various arenas such as G20 or the FSF working group. In addition, the SEC and JFSA became members of the FCAG and the IASCF Monitoring Board and involved positively.[21] That is to say, their involvements were changed from indirect ones to "high-level and multifaceted involvements" (Inoue et al., 2009, p. 47). In these changes, the governance reform were recognized as "the efforts of the International Accounting Standards Committee Foundation Trustees to enhance their, and the IASB's, accountability, legitimacy and independence" (IOSCO, 2008).

Although the IASB faced the crises of its legitimacy, and thus caused the crisis of the legitimacy of IFRS, the IASB conducted the governance reform in which the IASB included reference organizations into its own multilayered regulatory network and enhanced its public accountability (enhancement of '*superior organizations' delegation and/or acceptance of standard-setting activities*'). Moreover, the direct and multifaceted support from reference organizations and the stricter due process caused by the governance reform would ensure '*taking advantage of the power of other organizations*' of the legitimacy of IFRS and '*justification through organizational structure and due process*' of the legitimacy of IFRS. Restoration of the legitimacy of the standard-setter also functioned to maintain and restore the legitimacy of accounting standards with reflexive and homeostatic mechanisms.

5. CONCLUSION

The purpose of this study was to examine and clarify a legitimation mechanism of global accounting standard-setting and accounting regulation exposed by politicization of accounting. In particular, we investigated the legitimation crises of global accounting standards and their restoration process focusing on the IASB's response to the financial crisis.

This study finds that, during the financial crisis, a system of global accounting standards faced two legitimation crises: a possible loss of '*superior organizations' delegation and/or acceptance*' to the IASB and possibilities of another carve-out in other jurisdictions; and a possible loss of '*justification through due process*' of a legitimacy element of the IASB, and thus caused losses of '*taking advantage*

[21] For instance the G20 Pittsburgh summit, leaders' statement urged the IASB to accelerate its efforts to achieve a single set of high quality, global accounting standards within the context of its due process, to complete the convergence project by June 2011, and to enhance the involvement of various stakeholders (G20, 2009b, par. 14).

of the power of other organizations' or '*theoretical consistency*' of legitimacy elements of IFRS with reflexivity. Then, the IASB, in order to avoid another carve-out, decoupled '*theoretical consistency*' and '*justification through due process*' and tried to maintain the EU endorsement mechanism ('*the power of other organizations*'). And responding to concerns about issuing standards without regular due process from outside of the EU, the IASB established the Monitoring Board with compromising 'justification through organizational structure' (independence) and 'superior organizations' delegation and /or acceptance' and tried to maintain and restore the legitimacy of the IASB. Throughout these processes, the IASB systematically put a dominance position to the needs of the EU as the biggest customer based on the user needs principle of '*justification through organizational structure*.' In this manner, when the legitimacy of global accounting standards was at stake, the IASB restored its own legitimacy and also the IFRS's legitimacy by a reflexive mechanism.

This study makes several contributions. First, the primary contribution of this study is to the accounting literature. Especially, with using an analytical framework of 'decoupling, compromises, and systematic dominance,' this study shows the complicated mechanism of accounting standard-setting which the mere debates of the politicization of accounting could not reveal. Second, this study contributes to discussions about the legitimacy of organizations and institutions. In particular, our analysis indicates the legitimacy of input, procedure, and output could not exist stand-alone, but have a recursive relationship or reflexivity. Lastly, this study extends our knowledge of global financial regulations and our discussion offers numerous suggestions to globalization, especially the IASB's roles in the globalization of financial regulations, and regulatory forum or network centered on the IASB.

However, despite the usefulness insights it obtained, this study also has several future challenges. First, as this study suggests that the legitimacy of global accounting standards as a system were restored in the short term, but it is obscure whether this legitimacy would be maintained in the long term. In its Declaration, G20 called the governance reform of the IASB with a view toward promoting financial stability (G20, 2008). The IASB's stated objective of general purpose financial reporting is to provide decision useful information to existing and potential investors, lenders and other creditors (IASB, 2010, chap. 1); however, it is not clear that this objective and the financial stability can be co-existed. This ambiguity will suggest another tension between '*justification through benefits from application of IFRS*' and ‘*providing decision-useful information*’ of elements of the legitimacy of IFRS.

In addition, the IASB has been issuing accounting standards mainly focusing on developed countries; however, it should develop accounting standards more than ever considering developing countries because G20 presumed the IASB as global accounting standard-setter. The IASB now has a lot of reference organizations; therefore there should be conflicts among these reference organizations. This will suggest a possible distortion of ‘*superior organizations’ delegation and/or acceptance*’ of an element of the legitimacy of the IASB.

It is uncertain that the legitimacy of global accounting standards will maintain through reflexivity between the legitimacy of the IASB and that of IFRS in the medium and long term. These examinations clarify a comprehensive understanding of the legitimacy of global accounting standards.

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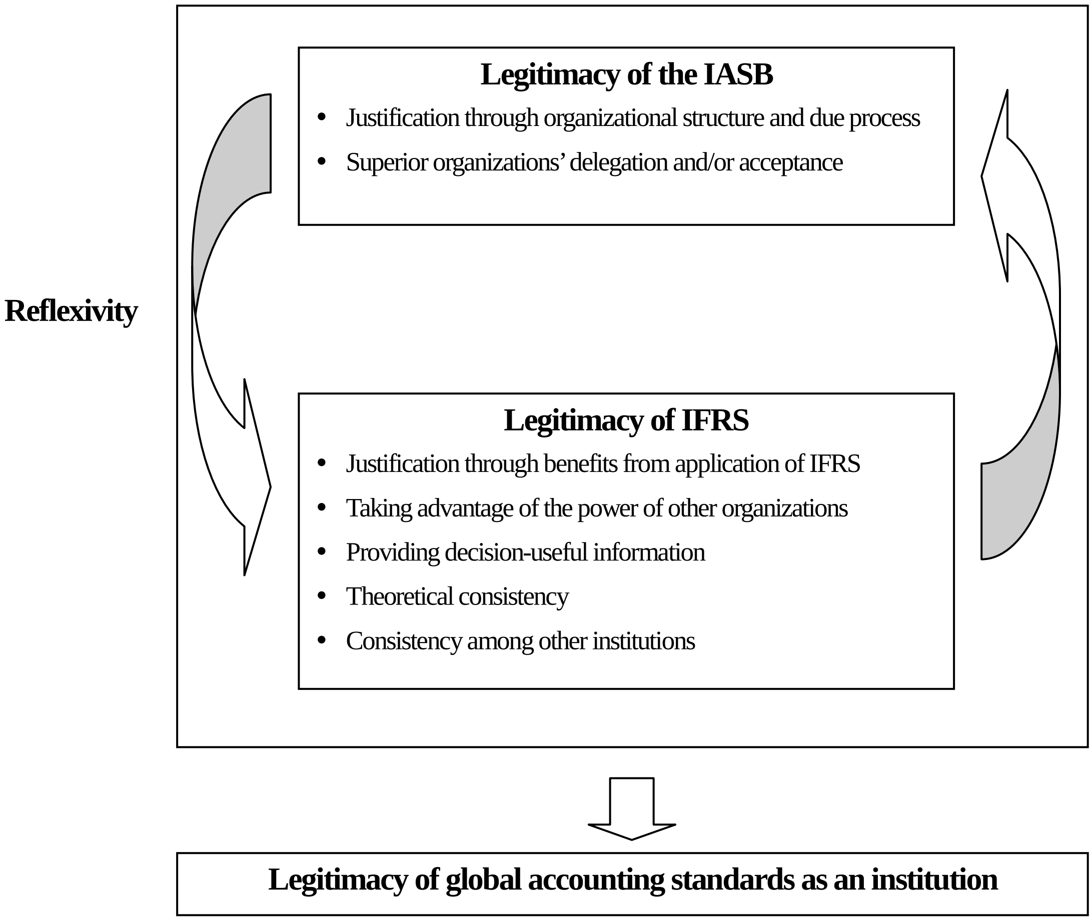
Figure 1 Legitimacy model of global accounting standards



Source: Sanada, 2012.