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Investigating international accounting standard setting: The black box of IFRS 6

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ABSTRACT

This paper examines the role of powerful entities and coalitions in shaping international accounting standards. Specifically, the focus is on the process by which the International Accounting Standards Board (IASB) developed IFRS 6, *Exploration for and Evaluation of Mineral Resources.* In its Issues Paper, the IASB recommended that the successful efforts method be mandated for pre-production costs, eliminating the choice previously available between full cost and successful efforts methods. In spite of the endorsement of this view by a majority of the constituents who responded to the Issues Paper, the final outcome changed nothing, with choice being retained. A compelling explanation of this disparity between the visible inputs and outputs of the standard setting process is the existence of a "black box", in which powerful extractive industries entities and coalitions covertly influenced the IASB to secure their own ends and ensure that the status quo was maintained.

Introduction

Accounting policies matter to corporations because they shape the distribution of income, wealth and perceptions of risks (Solomons, 1978, 1983; Willmott & Sikka, 1997; Zeff, 1978, 2002). It is now widely accepted that the development of accounting policies is a residue of political negotiations and bargaining amongst corporations and a political elite (Beresford, 1988; Mitchell, Puxty, Sikka, & Willmott, 1994; Mitchell & Sikka, 1993; Mitchell, Sikka, & Willmott, 1998; Sikka, Willmott, & Lowe, 1989). The politics of accounting policymaking are given visibility by the operations of the standard setting bodies, which need simultaneously to accommodate diverse demands and also secure their own legitimacy by portraying themselves as pluralistic, rational and objective.

With the expansion of economic globalisation, a considerable body of literature on accounting policymaking has focused on the processes of the International Accounting Standards Board (IASB), essentially a private sector standard setting body (Brown, 2004, 2006; Brown & Shardlow, 2005; Casabona & Shoaf, 2002; Ravlic, 2000; Touron, 2005; Zeff, 2002). Some of this literature exposes issues relevant across sectors and industries, such as accounting for intangible assets (Chalmers & Godfrey, 2006; Kwok & Sharp, 2005), financial instruments (Duangploy, 2007; Landsman, 2007), and business combinations (Briner & Fulkerson, 2001; Maines, Bartov, Beatty, & Botosan, 2004). As specialised accounting standards have also begun to emerge for specific industries or segments, scholars have begun to examine the standard setting process for banking (Jeffery, 2004; Landsman, 2007), insurance (Bodurtha, 2005; Mansfield & Lorenz, 2004), not-for-profit (Anon, 2006; Kilcullen, Hancock, & Izan, 2007) and small-medium-sized-business sectors (Sealy-Fisher, 2006; Woolfe, 2007). This paper contributes to this literature by examining the processes relating to the formulation of International Financial Reporting Standard 6 (IFRS 6) *Exploration for the Evaluation for and the*

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Evaluation of Mineral Resources. This standard is of particular significance to the extractive industries, which comprise oil, gas and mining companies.

An important issue in extractive industries accounting is the way pre-production activities, also known as exploration and evaluation activities, are accounted for. Historically, there have been two methods employed, the full cost method and the successful efforts method[2]. Under the full cost method, all acquisition, exploration, and drilling costs, including those relating to unsuccessful activities, may be capitalised and carried forward until such time as they can be written off against revenue from successful projects (Flory & Grossman, 1978). In contrast, under the successful efforts method, only those pre-production costs that relate directly to successful projects can be matched against revenue from the successful project (Katz, 1985). While both approaches are based on the historical cost concept of accounting, the method that produces the most favourable results depends on whether the reporting entity is small and in its early stages of exploration, or larger and more able to absorb the cost of unsuccessful efforts (Katz, 1985; Van Riper, 1994). The full cost versus successful efforts issue first became controversial in the United States (US) in the late 1960s when the Financial Accounting Standards Board (FASB) sought to narrow accounting alternatives and require oil and gas companies to reporting according to the successful efforts method (Van Riper, 1994). The effect on profits calculated under each method can be substantial; a recent switch in methods from full cost to successful efforts accounting caused one UK oil producer to restate its profits from $44 million to $22 million (Neveling, 2005).

The extractive industries is a sector dominated by global corporations and powerful extractive industries bodies whose income in many cases dwarfs the gross domestic product of many nation states (Cortese, Irvine, & Kaidonis, 2009). The purpose of this paper is to examine the role these powerful entities and coalitions play in shaping international accounting standards and recognise that their contributions may not always be visible but their influence certainly exists and permeates the accounting standard setting process.

To advance the analysis, this paper is constructed in the following sections. First, the black box concept is proposed as a means for understanding and examining the international accounting standard setting process (Hodges & Mellett, 2008). This is followed by a discussion of standard setting and IFRS 6, which contextualises the IASB[3] and its processes, presents an overview of the extractive industries and provides evidence of the enormous economic strength of this sector. The visible inputs, for example, the exposure draft and responses, are examined in light of the visible output of the standard setting process, IFRS 6. Concluding comments reflect on the disconnect between the visible input and visible output and infer the existence of a black box in the standard setting process within which the unseen influences of powerful constituents act as a countervailing force against visible opinion.

The black box

Much of the extant research on accounting and the extractive industries has been based on the assumption that "facts" can be gained by observation of consistencies and causal relationships, which are then assembled into generalisable empirical patterns of accounting practice (Agger, 1998; Chua, 1986; Hopper, Annisette, Dastoor, Uddin, & Wickramasinghe, 1995; Lodh & Gaffikin, 1997; Mouck, 1992). A multitude of investigations into accounting for the extractive industries emerged following the FASB's controversial proposal in the late 1970s to eliminate the full cost method of accounting for pre-production activities and require entities to report under the successful efforts method. Many of these studies examined the market effects of the proposed change in accounting method (Amernic, 1979; Baker, 1976; Collins & Dent, 1979; Dyckman, 1979; Dyckman & Smith, 1979; Lawrie, 1986). Other research investigated the relationship between the choice of the full cost or successful efforts method and company characteristics such as size, age, exploration aggressiveness and/or success, and demand for capital (Deakin, 1979; Lilien & Pastena, 1981). Research also attempted to predict reasons for switching between accounting methods (Johnson & Ramanan, 1988; Nichols, 1993), and tested the relationship between successful efforts and full cost data and company share price (Al Jabr & Spear, 2004; Bandyopadhyay, 1994; Berry et al., 1985; Bryant, 2003).

Given the positivist, statistics-based research that has dominated this area, there is space in the literature for a study of the *process* of setting an international accounting standard and the influences that shape IFRSs. It is important that the process be seen as subjectively created and grounded in social and historical practices (Hines, 1988; Miller, 1994; Walker & Robinson, 1993, 1994). It is important to recognise the efforts of participants within standard setting processes and their influence over the content of rules developed and also the institutional environment within which these rules are considered (Brown, 2004, 2006; Brown & Shardlow, 2005; Zeff, 2002).

Hodges and Mellett (2002) provide an example of research into the process of accounting standard setting. They examined the UK standard setting process and raised the notion that unseen or hidden influences could also play a role in the standard setting process. They stressed that investigations should not be restricted to observable lobbying activity and public submission statements, arguing that extant accounting standard setting literature did not sufficiently acknowledge influences that were not publicly visible (Hodges & Mellett, 2002). In a follow up to their 2002 study, Hodges and Mellett (2005) conducted a series of interviews and found that there was considerable discussion between regulators and interested parties

[2] A derivative of the successful efforts method, known as the Area of Interest method, was developed by Australian accounting standard setters in the 1970s. This method allows costs to be capitalised when they relate to a successful venture, which is defined within a specific area of interest such as a single mine or a separate oil or gas field (Australian Accounting Standards Board, 1989).

[3] The International Accounting Standards Board (IASB) was formed in 2001. Its predecessor, the International Accounting Standards Committee, was initially responsible for adding the extractive industries project to its agenda.