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The Influence of Accounting Standard Precision on Auditors Decisions

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Abstract

Accounting standards such as lease standard can be applied opportunistically by managers to manipulate the economic substance of transaction. This phenomenon is reduced by using the principles-based accounting standard. The purpose of this paper is to investigate the effect of principles-based versus rules-based accounting standard and audit committee on constraining aggressive financial reporting. This research manipulated with the type of accounting standards (principles-based and rules-based) and the type of audit committee (strong and weak) in the auditors group. Our results indicate that auditors are less likely to report aggressively under a less precise (principles-based) standard than under a more precise (rules-based) standard. Also, we find no effect of audit committee on the aggressively financial reporting. This result suggests that accounting standard setters can move in direction of the less precise standards to improve the financial reporting quality.

Keywords: standard precision; rules-based standard; principle-based standard and audit committee.

Introduction

Acceptance of a global set of accounting standards such as the International Financial Reporting Standards (IFRS) as early as 2015, newly recertified support by Securities and Exchange Commission (SEC) (Backof et al, 2014). The standard setters use the rules-based and principles-based standard approaches. Principles-based accounting standards refer to a system of financial reporting that is based primarily on the fundamentals of accounting (i.e. decision usefulness, true and fair view, going concern, substance over form) and implying extensive opportunities for professional judgment (Van Beaet,2009). In principles-based accounting standard is more clearly conveys the economic substance of transactions and so, the important of professional judgment is increase. In Contrary, Rules-based accounting standards are interpreted as a system of financial reporting, that is based on detailed guidance and possess more bright line tests as well as exceptions to the principles underlying the standard. Nelson, (2003) and Schipper (2003) suggest that comparability between financial reports is increased by using precise standards and auditors face better opportunities to verify reporting information.

The move towards a principles-based approach in accounting standards has been begin after the occurrence the accounting fraud such as Enron, WorldCom and Tyco and the U.S. Congress passed Sarbanes-Oxley Act (SOX). This events lead to the Securities and Exchange Commission (SEC) and Financial Accounting Standard Board (FASB) to consider amend programs to forbid aggressive financial reporting. These reforms contain a move toward more principles-based accounting standards and raising the role of the audit committee. Regard to International Financial Reporting Standard (IFRS) is principles-based and U.S. Generally Accepted Accounting Principles

(GAAP) is rules-based; it is concerns about the change position to International Financial Reporting Standard (IFRS) and adaption of principles-based standards. The one of challenges in accounting standard approaches is whether auditors can restrain managers' aggressive financial reporting under IFRS without the bright lines present in U.S. GAAP (Backof et al, 2014, Agoglia et al, 2011, Jamal and Tan, 2010). Nelson (2003) believes that aggressive reporting is bias elements of the financial statements either upwards or downwards. In addition to, aggressive reporting can define as the practice of the financial reporting prepares in using the accounting procedures in order to manipulate financial statement items to make a company appear more attractive to investors. The primary and main question of this study is whether auditors can constrain managers' aggressive financial reporting under the principles-based accounting standard or not.

We posit that auditors by using the less precise standard (principles-based standard) can to limit managers' propensity to engage in aggressive accounting reporting practices. Also, the second hypothesis investigates effect the interaction of between audit and accounting standard approaches on aggressive accounting reporting.

Our motivation for this study is decrease in concern related to the role of auditor on the effect accounting standard approaches on aggressive financial reporting and consequently on the financial reporting quality. The other motivation is the role of audit committee as a mentoring mechanism on the management opportunities behaviors and its effect on the auditor's judgment in restrain aggressive financial reporting.

This paper contributes to the accounting standard approaches literature on the effect rules-based versus principles-based accounting standard on aggressive financial reporting. Considering of differences in culture and judgmental skills of auditors, our results clear useful evidence on the dissert regard to the efficacy of principles- versus rules-based standards in the developing country.
The remainder of the paper is organized as follows: Section 2 present accounting standard setting in Iran. Section 3 illustrates relevant prior studies. Section 4 describes hypothesis development. Section 5 describes research methodology and research sample. Section 6 presents and discusses the empirical results of this study. Finally, Section 7 gives a brief summary and conclusion.

Accounting Standards Setting in Iran

Accounting standard is prepared by Audit Organization (AO) in Iran. Audit Organization (AO) is established as a state body in 1987 by the merge of three aforementioned audit firms: the Nationalized Industries and Plan Organization Audit Firm (1980), the Mostazafan Foundation Audit Firm (1981) and the Shahed Audit Firm (1983).Audit Organization is the only regulatory body for accounting and audit standards setting.
Accounting standards setters in Iran did not adopt the International Financial Reporting Standards (IFRS) and all companies required to use the Iranian National Accounting Standard (INAS) when prepare financial reporting. Although Audit Organization has not accepted the International Financial Reporting Standards (IFRS), Iranian National Accounting Standard is developed based on the IFRS.

Literature Review

In this section the several of studies have been recently presented that are related to auditors' judgments and accounting standard precision and their effects on aggressive financial reporting.
Backof et al (2014) response to the question whether another judgment guidance aid Big 4 audit managers and partners to restrict management's aggressive financial reporting in condition that accounting standards precision differ. The research method is based on the case. 219 practicing audit managers and partners participated in this experiment using a 2×4 factorial design. They find that

when accounting standards are less precise and using a judgment framework, auditor are less likely to accept aggressive financial reporting. But, in condition that absence a judgment framework the auditors are more likely to allow aggressive reporting.

Tsunogaya et al (2014) investigate the impact of type of lease accounting on the judgments of Japanese professional accountants. The research method is based on the scenario. They examine whether a principles-based accounting standard with rules and guidance amends the judgments of accountants and more explicitly transfers the economic substance of transactions. 112 Japanese Certified Public Accountants (CPAs) participate in experiment and in this research contained two scenarios. The results indicate that principle-based and rule-based had a positive and negative effect (respectively) on encouraging Japanese professional accountants to recognize lease transactions.
Peytcheva et al (2014) examines how the type of accounting standard influences auditors' cognitive motivations and demand for audit evidence. U.S. and Dutch auditors are participating in experiment design. The result suggests the important influence of accounting standards on auditors' motivations and consequent program planning decisions.

Cohen et al (2013) response to the question whether higher-quality financial reporting will be increase with the adoption of a principles-based approach, such as IFRS. They employ 97 experienced auditors as participants. Using a scenario setting include the classification of a lease, they can manipulate accounting standard and the regulatory regime. The result indicates that auditors are more presumably to restrict aggressive reporting under principles-based accounting standards than under rules-based standards, under both stronger and weaker regulatory regimes.
Agoglia et al (2011) examine the influence of standard precision and audit committee strength on aggressive financial reporting. This research used case for the test of hypotheses. 96 experienced financial statement preparers participate in experiment and used a 2×2 factorial design. They find that the more principle-based standard than more rules-based lead to participations have less likely to report aggressively. Also, the result indicates that when the standard is less precise, audit committee strength is not affect but in the presence of a strong audit committee than a weak audit committee and using a more precise standard is less likely for aggressive financial reporting.
Jamal and Tan (2010) investigate of joint effects of principles-based versus rules-based standard and auditor type in restricting financial managers’ aggressive reporting. 90 financial managers are participating in experiment and employed a 2×3 between-subjects design. They results indicate that with a rules-based standard, auditor-type does not influence managers’ tendency to take the proposed lease transaction off balance sheet. The result reveals that the auditor-type is important in a principles-based standard and thus, in compare to the condition which the auditor is rules-oriented or client oriented, the tendency to take the selected of operation lease is lowest when the auditor is principles-oriented.

Overall, examine of prior research show that the constraining aggressive reporting by management in both a rules-based and principles-based reporting environment is converted a challenges for Auditors (Cohen et al, 2013). Rules-based accounting standards that include bright-lines can authorize to preparers to forms transactions in order to meet the “bright lines” and may thus encourage a “check-the-box” approach (Schipper, 2003). However, principles-based accounting standards are in substance less violent and, thus, allow management more discretion and judgment (Cohen et al, 2013). Thus, it expect that in presence principle- based accounting standard, prepares can justify their reporting choices hardly because of both auditors and regulators are monitor on the financial reporting. Agoglia et al (2011) and Jamal and Tan (2010) studies suggest that internal and external monitoring factors can restrict aggressive management reporting behavior under principles-based and rules-based accounting environments.

Hypothesis Development

Accounting financial reporting is useful when it prepares a base on the accounting standard. The rule-based and principle-based approach is used for the setting of accounting standard. In the accounting literature it is believed that International Financial Reporting Standards (IFRS) is used the principles-based for the setting of accounting standard, whereas U.S. Generally Accepted Accounting Principles (GAAP) is considered as the rules-based. Rules-based standards typically include very detailed guidance with bright-line tests. A perceived benefit of more detailed implementation guidance is greater comparability of financial statements across companies (Agoglia et al., 2011). However, excessively detailed reporting guidance can lead to the company structure the transaction and have motivate to the interpretation of standard to achieve preferred accounting treatments (Bockus et al. , 2003 and Nelson , 2003).

The prior study such as Benston et al. (2006) states that because of demand for Rules-based standards by financial statement preparers and auditors, using this approach are increased gradually. Financial statement preparers and auditors believe that such detailed rules protect them from potential criticism for aggressive financial reporting (Benston et al., 2006). The research study of Maines (2007) reveal that in presence a less precise standard, it is more difficult to justify the aggressive financial reporting because of in the threshold of less precise standard is not explicitly stated. Thus, we expect that using the less precise standard cause to auditors to exercise substantially more professional judgment during the financial reporting process and result in a decrease of aggressive financial reporting. Considering the above explain the research such as Bedard et al (2004) and Agoglia et al (2011), we proposed the following hypotheses:

H_1: Auditors using a less precise financial reporting standard will be less likely to make an aggressive financial reporting decision than Auditors using a more precise standard.

The audit committee represents a key corporate governance mechanism, in that it is viewed as one of the most important monitors of the financial reporting process (Blue Ribbon Committee, 1999). The role of audit committee in company can include the responsible for select the company's independent auditor, supervising the work of the auditor, resolving the issue between management and the auditor, and monitoring internal controls. Consequently, the financial reporting quality is increase if the company has the strong audit committee. The strong audit committee members have independence and expertise in the accounting and audit work. The prior research such as Bedard et al (2004) and Agoglia et al (2011) this notion is appears that audit committee independence, experience and activity can enhance the monitoring and supervise of management which result to less aggressive financial reporting. Thus, we expect that interaction between audit committee and accounting standard setting approach have the effect on the aggressive financial reporting. Considering the above explain and the research such as Bedard et al (2004) and Agoglia et al (2011), we proposed the following hypotheses:

H_2: The interaction audit committee and more precise standard lead to the auditor judgment about aggressive financial reporting decision are different from the auditor judgment with the interaction the audit committee and less precise standard.

Participation and Research Design

The statistical sample of research participation includes 120 auditors (22 audit manager, 36 senior audit supervisor, 35 audit supervisor and 28 junior auditor), which were selected by classified random sampling method. The average of auditors experience is 8.75 year.

The data was collected by a questionnaire-based survey among auditors who were working at audit firms in Iran. A total of 120 auditors were distributed a requesting their participation in the

questionnaire survey (60 auditor received the rule-based scenario and 60 auditor received the principle-based scenario).

Our research scenario is consistent with Agoglia et al. (2011). A research instrument includes four sections. The first section, the auditors read the guidelines for classifying a lease as either a capital or operation lease. Auditors used only on criterion i.e. the estimated economic life for the lease classification decision. In the more precise standard, the lease is capital if the lease term is "equal to 75% or more" of the estimated economic life of the leased property and in the less precise standard, the lease will be capitalized if the lease term is "for the major part" of the estimated economic life of the leased property (Agoglia et al., 2011). In secondary section were told that to assume the role of auditor for an artificial company that intend to a lease a new plant with an estimated economic life of ten years. Participants were asked that a lease be classified as an operating lease if it does not meet the capital lease criterion. The lease term determined for all auditors as the fixed non-cancellable term of the lease plus all periods covered by bargain renewal options. All participants were stated that a bargain renewal option happen when the lessee has the option to renew the lease for an amount sufficiently lower than the fair rental of the property such that exercise of the option appears, at the inception of the lease, to be reasonably assured (Backof et al., 2014). Therefore, the lease term related on participants' reorganization of whether any renewal option included in the lease was a bargain. Once this determination was made, auditors had to exercise their judgment to determine whether the lease term met the criterion considered in the standard for capitalization.

All participants wanted to assume that they were the auditors of ABC Company. ABC just entered into a lease for new equipment with an estimated economic life of ten years to be used to produce a new product. The lease has a non-cancelable lease period of seven years. Considering the agreement, the firm has options to renew the lease for an additional year with the monthly rental payment at the end of the initial non-cancelable lease period. It sets a rate that permits for some authorization in judging whether the renewal option represents a bargain (Agoglia et al., 2011). Further, the case explained that management was ambiguous about the decision to activate the option to renew the lease because the uncertainty over the achievement of the new product. Thus, ABC believed that the transaction should be classified as an operating lease. Participants were then provided with a summary of the impact of the alternative lease accounting treatments on the company's financial statements and key ratios such as EPS and return on assets and a debt-to-equity ratio at the end of the first year of the lease. Participants were also told that ABC had plans to expand its plant to meet the growing demand for one of its other products. However, the company can take a loan for this expansion if ABC's total liabilities/total equity ratio is less than a set threshold. Thus, the case provide very strong motivates to classify the lease as an operating lease. After considering the case information, participants recorded their lease classification decisions on a ten-point and finally, participants answered several post-experimental and demographic questions (three and four sections).

Results

We conducted an experiment using an 2×2 ANOVA which used standard precision and audit committee as an independent variable and the lease classification decision of auditor as the dependent variable.

Table 1, Panel A presents the descriptive statistics for the proration of auditors who selected to record the either operation or capital lease. Panels B show the categorical ANOVA results. Our H_1 hypothesis express that with more precise standard than less precise standard, auditors will be more

likely to make an aggressive financial reporting. As Table 1 shows that for more precise standards, the mean of participations response are 4.90 and the mean of participations response are 7.04 for less precise standard. Considering F-test (F=22.34, P <0.00), we find a statistically significant between precise standard and financial reporting. So, this hypothesis is consistent with expectations. In the other words, auditors are more likely to report aggressively when presented with a more precise standard than with a less precise standard.

Regarding our H_2 hypothesis, Table 1, Panel B shows that audit committee is not significant (F=1.80, P < 0.18, significant at or below the 0.05 level). Also, Table 1, Panel B reveals that the interaction of between accounting standard precision and audit committee is not significant (F=0.32, P <0.57, significant at or below the 0.05 level). So, this hypothesis is not consistent with expectations. In the other words, these results indicate that audit committee has not a greater effect on aggressive reporting in a rules-based regime than in a more principles-based regime. We estimate the Levene's test for equality of variances the between weak and strong audit committee. This result indicate a no significant difference between two groups (SD=2.77 and 2.64 , F=0.431, P<0.51). This result provides the further evidence for rejects our H_2 hypothesis.

Table 1: Descriptive Statistics

Panel A: Mean (Standard Deviation)			
	Audit Committee		
Standard Precision	Weak	Strong	Overall
Less Precise	6.86	7.21	7.04
	(2.41)	(2.43)	(2.41)
	N=30	N=30	N=60
More Precise	4.46	5.33	4.90
	(2.60)	(2.55)	(2.59)
	N=30	N=30	N=60
Overall	5.66	6.30	
	(2.77)	(2.64)	
	N=60	N=60	
Panel B: ANOVA Results			
	F Test		P-Value
Corrected Model	8.19		0.00
Accounting Standard Precision	22.34		0.00
Audit Committee	1.80		0.18
Accounting Standard Precision* Audit Committee	0.32		0.57

To further examine the effect of standard precision, we divide the response of auditor to the two parts. Table2 present the analysis of lease classification. In the more precise standard position, fifty-seven percent of and forty-three percent of auditors classified lease as operation and capital lease, respectively. Also, thirty-three percent of and sixty-seven of participations selected lease as operation and capital lease (respectively) in the less precise standard condition. Considering the above result, we can express that fifty-seven percent of auditors in the more precise condition classified it as an operation lease versus sixty-seven percent in the less precise condition. Thus, the result indicate that auditors in the more precise standard position are significantly more likely to take

the aggressive position of classification the less as an operation lease than those using a less precise standard. This result is the further support for our H_1hypothesis.

Table 2: Contingency Analysis of lease Classification Decision By Standard Precision Condition

	lease Classification Decision		
Accounting Standard Precision	Operation Lease	Capital Lease	Row Total
Less Precise	20	40	60
Row%	33.33%	66.66%	100.00%
More Precise	34	26	60
Row%	56.66%	43.44%	100.00%
Column Total	54	66	
	$x^2 = 7.36$ $(P < 0.007)$		

Conclusions

Financial statement appears the useful information for users and it prepared the base on the accounting standard. The financial reporting prepares have a tendency which used the accounting standard in direction the management and company interest and thus, they prepare financial statement aggressively. The financial reporting prepares employ accounting standards for receive the aim. Rules-based accounting standard allow to preparers to structure transactions in order to meet the “bright lines”, while principles-based accounting standard reflect the economic substance of a transaction and thus, preparers have less discretion to the manipulation of transaction. Thus, the purpose of paper is to investigate the effect of accounting standard setting approaches and audit committee on the aggressive financial reporting.

We conduct an experiment to investigate who auditors make judgment about aggressive reporting under accounting standards approaches. In this paper, we assume accounting reporting is aggressive if it is biased toward which providing the management interests.

We find evidence that auditors are more likely to report aggressively when meet with a more precise standard than with a less precise standard. Thus, when auditors faced in condition that has the need of judgment, it is less likely allow issuing aggressive financial reporting under the less precise standard. This result is consistent with the notion that using the less precise standard can increase the financial reporting quality. This result is consistent with the prior research such as Agoglia et al (2011) and Cohen et al (2013). Also, we find that audit committee as a monitoring system have not effect on aggressive financial reporting and the interaction of accounting standard and audit committee have not effect on aggressive financial reporting. This result is inconsistent with prior research such as Agoglia et al (2011).

This pioneering study contributes to a better understanding of the unique features of Iranian auditors’ judgments under rules-based versus principles-based accounting standard. A primary message of our paper is that a better reporting environment is created only if the accounting standards are principles-based.

According to the presented result, we recommend accounting standard setters and regulators switch from rules-based to principles-based accounting standards because of this result indicates that moving toward more principles-based standards can prevent the opportunistic reporting by financial

statement preparers. Considering the lease accounting may not be representative of all accounting standards, the limitation of study is that the accounting standard restricted to lease accounting.

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