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The impact of different types and amounts of guidance on the implementation of an accounting principle

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ABSTRACT

Transfer of asset control is a central principle in the revenue recognition standard jointly developed and issued by the FASB and IASB (Boards) in 2014. Guidance with respect to this principle will be very important in applying the new standard. This study examines the effect of type and amount of guidance on the judgment of whether control has been transferred. Study participants receive different hypothetical standards and provide judgments with respect to the transfer of control in a construction-type contract case setting. Results indicate that adding guidance to the basic principle in the form of either key indicators or an illustrative example results in participants being more likely to judge the customer as having control during the construction period. Participants perceive indicators as being more useful than examples in forming their judgments. The nature of the example (affirmative or counter) does not have a differential impact on judgments when added to a principle-only standard. On the other hand, when an example is added to a standard that contains a principle and key indicators, judgments are significantly different when a counter example is present than when an affirmative example is part of the standard. This study provides the Boards with research results that may be useful in determining the type and amount of guidance to be provided in a principle-based standard.

1 Introduction

International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB) often are described as being principles-based, whereas standards developed by the U.S. Financial Accounting Standards Board (FASB) are viewed as being more rules-based. In fact, no standard is based solely on a principle; every standard contains some amount of implementation guidance.[1] Guidance for the implementation of an underlying principle can be provided in a variety of forms, including key indicators to be considered in applying the underlying principle, illustrative examples to be compared against, and, in the extreme case, bright-line criteria.

The recent experience of the FASB and IASB (hereafter the "Boards") in developing a new standard on revenue recognition suggests that deciding on the type and amount of guidance to provide for implementation of a basic principle is not a cut-and-dry process.[2]

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[1] A white paper issued by the CEOs of the six largest accounting firms states: "…we may be well served by acknowledging that neither a purely rules-based nor a purely principles-based system has ever existed or will ever exist. Every accounting standard will exist somewhere along a spectrum between rules and principles" (DiPiazza et al., 2008, 2). Similarly, Nelson (2003) describes accounting standards as being more or less rules-based (or "precise"), with less precise standards relying more on principles to guide behavior than on detailed guidance.

[2] This conclusion is supported by the fact that the Boards' Discussion Paper (IASB, 2008 and FASB, 2008), subsequent discussion (IASB, 2009), Exposure Draft (IASB, 2010 and FASB, 2010), and revised Exposure Draft (IASB, 2011 and FASB, 2011) related to revenue recognition contain differing amounts and types of implementation guidance in the form of key

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In the only extant study to directly examine the impact of additional guidance in an accounting standard, Clor-Proell and Nelson (2007) investigate whether the manner in which an illustrative example is framed (affirmative vs. counter) affects the way in which a standard containing an illustrative example is applied. They find that individuals are more likely to recognize both revenue and expense when provided an affirmative example than when provided a counter example. Further, providing subjects with both types of examples does not reduce the overweighting of the affirmative example. Their results are consistent with the cognitive constructs of “priming” (Kahneman & Tversky, 1984; Tversky & Kahneman, 1973) and “similarity comparison reasoning” (Holyoak & Thagard, 1997). Rather than, or in addition to, providing guidance in an accounting standard in the form of an illustrative example, the Boards can provide key indicators to guide application of the underlying principle.[3] This study attempts to extend prior research by examining not only the influence of illustrative examples but also the impact that providing key indicators to a principle-based standard has on financial reporting judgments. This study further contributes to prior research by examining the relative importance of providing key indicators versus illustrative examples as additional guidance, as well as the possible interaction between these two types of guidance. The impact of including key indicators and/or illustrative examples in an accounting standard is examined by conducting a study with student participants that uses revenue recognition in a construction-type project as the context for a judgment-making exercise.[4]

A general principle in the Boards’ new revenue recognition model is that an entity should recognize revenue when the performance obligation in a contract is satisfied by transferring control of an asset to a customer. Judging whether control of an asset has been transferred is critical in applying the underlying principle. This study manipulates the presence of key indicators and the presence and nature of an illustrative example to determine the impact these elements have on the judgment of whether control has been transferred from an entity to a customer, and whether these two elements interact.[5] It also examines the effect these two elements have on participants’ confidence in their judgment.

Results indicate that adding guidance in the form of key indicators or an illustrative example has a significant effect on participants’ judgments as to whether the customer has control during the construction period. In response to a post-judgment task question, participants generally indicate that the indicators were used more than the examples. Contrary to the results obtained by Clor-Proell and Nelson (2007), the nature of the example (affirmative or counter) does not matter when added to a principle-only standard. However, the nature of the example does matter when added to a standard that also contains key indicators (i.e., there is a significant interaction between the two types of guidance). Results also show that providing additional guidance, through the introduction of either indicators or an example, does not significantly affect participants’ confidence in their judgment. However, adding both indicators and an example does result in a significant increase in participants’ confidence in their judgment.

In addition to extending prior literature examining the effect of providing additional guidance in a principle-based standard, this study provides information that might be useful to the Boards in developing such standards. Although this study examines the effect of additional guidance in the context of revenue recognition in construction-type contracts, the results of this study could be generalizable to other contexts.

The next section presents background and develops hypotheses. The research method is described in the following section, and then results are presented. The final section provides a summary and offers conclusions.

2 Background and hypotheses

2.1 Indicators and examples

Both the FASB and IASB provide additional guidance in numerous standards to assist financial statement preparers in applying the standard.[6] Guidance provided in the form of key indicators tends to be general and avoids establishing specific criteria or thresholds. As an example, FASB Accounting Standards Codification (ASC) Topic 830-10 (Foreign Currency Matters) establishes the principle that the “assets, liabilities, and operations of a foreign entity shall be measured using the functional currency of that entity” (par. 45-2). ASC 830-10-55-5 provides a list of indicators that “should be considered both individually and collectively when determining the functional currency,” but it does not provide guidance with regard to how the indicators should

indicators and illustrative examples. For example, the Discussion Paper and original 2010 Exposure Draft contain different illustrative examples related to construction-type projects; however, such an example is absent from the revised Exposure Draft and from the final standard (FASB, 2014; IASB, 2014).

[3] Key indicators are additional elements of guidance (somewhat like criteria) that are intended to assist preparers in applying the concept. More detailed discussion of key indicators is presented in Section 2.1.

[4] The motivation for choosing the revenue recognition standard to investigate was twofold. First, this standard is timely and highly relevant. It is the most recent successful joint project completed by the FASB and IASB, and because of the pervasive nature of revenue recognition, it arguably is one of the most important joint standards issued by the Boards. Second, the history of its development (described in Section 2.2. below) exemplifies the difficulty the Boards experienced in deciding on the amount and type of guidance to provide in the final standard. As such, it provides a natural setting for examining the impact of different additional guidance on the implementation of an accounting principle.

[5] Clor-Proell and Nelson (2007) suggest that the amounts of guidance and type of example might interact, with examples playing a more important role in application of the standard when the standard otherwise is less precise. They do not test this hypothesis.

[6] A large number of Topics within the FASB Accounting Standards Codification (ASC) contain “Implementation Guidance and Illustrations” (Section 55). Examples include ASC 360 (Property, Plant and Equipment), ASC 470 (Debt), and ASC 830 (Foreign Currency Matters). Many IASB standards contain one or more of the following sections: “Application Guidance,” “Implementation Guidance,” and/or “Illustrative Examples.” For example, IFRS 9 “Financial Instruments,” contains all three sections of additional guidance.