Contents lists available at ScienceDirect

International Journal of Accounting

journal homepage: www.elsevier.com/locate/intacc

Implementation Guidance for Standards and Revenue Trend in Aggressive Reporting☆

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ARTICLE INFO

Keywords:
Implementation guidance
Indicators
Revenue trend
Aggressive reporting

ABSTRACT

This study examines the interactive effect of including the implementation guidance in accounting standards (with and without indicators) and different reported revenue trends (increasing, decreasing, and volatile) in aggressive reporting. For this purpose, we adopt a 2 × 3 between-subjects experiment. Aggressive reporting is measured by managers' perception of control and judgment regarding revenue recognition. The results of this experiment indicate that including the implementation guidance can constrain managers' revenue recognition judgments. The results show that for decreasing revenue trends, the inclusion of indicators for implementation does not influences managers' judgments regarding revenue recognition. For increasing revenue trends, the inclusion of guidance indicators matters in that the managers' judgments regarding revenue recognition are more aggressive in conditions without indicators than in conditions with indicators. The findings of this study extend the literature on implementation guidance in accounting standards and aggressive reporting.

1. Introduction

Some researchers have argued that principles-based accounting standards motivate managers to use the latitude the standards provide and engage in manipulative actions (Brown & Wright, 2008; Fornaro & Huang, 2012). To clarify the standards, standard setters include implementation guidance. The inclusion of implementation guidance in an accounting standard can create two distinct situations. On one hand, it can clarify the concept addressed and its application, which results in better comparability among financial statements. On the other hand, preparers may unconsciously match accounting transactions with the implementation guidance provided, resulting in reporting on the form rather than their substance of the transactions (Capps, Koonce, & White, 2014; Clor-Proell & Nelson, 2007). Implementation guidance, in this instance, might facilitate opportunities for parties to structure transactions that are aligned with a desired reporting outcome (Audsabumrungrat, Pornupatham, & Tan, 2016; Degeorge, Patel, & Zeckhauser, 1999; Wheeler & Arunachalam, 2008).

The extent literature findings regarding consequences of the implementation guidance on financial reporting behavior are inconclusive. To some extent, the presence of incentives may explain the inconsistencies in the relationship between the impact of implementation guidance in accounting standards and financial reporting behavior (Cuccia, Hackenbrack, & Nelson, 1995). These

☆ Acknowledgment: We would like to express our gratitude to Hun-Tong Tan from Nanyang Technological University, Singapore, the editors, and two anonymous reviewers for their constructive feedback and guidance.

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http://dx.doi.org/10.1016/j.intacc.2017.09.001
Received 27 June 2016
0020-7063/ © 2017

Please cite this article as: Lim, Y., International Journal of Accounting (2017), http://dx.doi.org/10.1016/j.intacc.2017.09.001

incentives might motivate and direct the managers' decisions in a manner that does not serve stakeholders' interest (Baker, Collins, & Reitenga, 2009; Nelson, Elliott, & TarpIey, 2002). When serving the interests of shareholders has negative consequences, managers may utilize the implementation guidance in accounting standards as "legal" grounds to rationalize, defend, and legitimize a reporting decision (Audsabumrungrat et al., 2016; Wheeler & Arunachalam, 2008). Additionally, indicators are a form of implementation guidance because they clarify the ambiguity in a standard to assist preparers in applying the relevant accounting principle in the financial reporting and decision-making process (Nelson, 2003). They are key measures that assist in evaluating the progress and performance of the decision-making process (Franceschini, Galetto, & Maisano, 2007). For example, a company's hiring rate is a good indicator of its attractiveness as an employer (Weber, 2008).

To develop more understanding of the relationship between accounting standards and aggressive reporting, we conducted a 2 × 3 between-subjects experiment to examine the interactive effect of including implementation guidance in an accounting standard (with and without indicators), combined with the presence of the incentives of different reported revenue trends (increasing, decreasing, and volatile) on managers' aggressive reporting. Aggressive reporting is measured by managers' perception of control and judgment regarding revenue recognition. The inclusion of implementation guidance was determined by the inclusion of indicators that further prescribe when control of goods or services is considered transferred to customers consistent with the International Financial Reporting Standard (IFRS) 15 *Revenue from Contracts with Customers*. In the condition with indicators present, participants were given an excerpt from IFRS 15 that prescribes the concept of control, together with a list of indicators that further prescribes when the control of goods or services is considered transferred to customers. In the condition without indicators, participants were provided with the same excerpt after deleting the list of indicators. The revenue trend was chosen as an incentive under the assumption the market values such performance measures (Barton, Hansen, & Pownall, 2010; Ghosh, Gu, & Jain, 2005).

Our findings reveal that under increasing revenue trends, the inclusion of indicators matters in that the revenue recognition is more aggressive under conditions without indicators than conditions with indicators. By conducting this study, our contribution to the literature is as follows. Our study examines the inclusion of indicators as a form of implementation guidance and whether such inclusion influences managers' financial reporting decision making after taking into account the effect of the revenue trend incentive. While much debate has occurred on the impact of examples in principles-based accounting standards (Clor-Proell & Nelson, 2007; Mala & Chand, 2014), less attention has been given to the impact of indicators as implementation guidance in a set of principles-based standards.

This paper is organized as follows. The next section (Section 2) describes the background of the study. The literature review and hypothesis development are discussed in Section 3. The study's research methodology (Section 4), a discussion of the findings (Section 5), and conclusions from the study (Section 6) are then presented.

2. Background of the study

The International Accounting Standards Boards (IASB) and the Financial Accounting Standards Boards (FASB) (the boards), introduced in May 2014, a significant change to the current revenue recognition practice. Unlike International Accounting Standard (IAS) 18 *Revenue*, where revenue is recognized when the risks and rewards of the goods and services have been transferred to customers, Paragraph 38 of IFRS 15 *Revenue From Contracts with Customers* prescribes a five-step revenue recognition model in which revenue may only be recognized when control of the goods and services has been transferred (KPMG, 2014; PWC, 2014). Indicators prescribed to mark when control has passed include the following:

(a) The entity has a present right to payment for the asset.

(b) The customer has legal title to the asset.

(c) The entity has transferred physical possession of the asset.

(d) The customer has the significant risks and rewards of ownership of the asset.

(e) The customer has accepted the asset.

The concept of control was presented in general form when the standard was first introduced in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* in December 2008. Due to public demand for clarification of the concept, the initial concept of control was modified to include a list of indicators in the first exposure draft issued in June 2010 (ED/2010/6), *Revenue from Contracts with Customers,* with the aim of assisting the public in determining when control has passed and, hence, recognition of revenue. These lists of indicators were retained in the second exposure draft issued in November 2011 and in the adopted standard IFRS 15. The inclusion of indicators as a form of implementation guidance in a set of principles-based standards in response to the concern of the public (Brady, Gagnon, Bement, & Rees, 2010). While some have welcomed such move as it helps to clarify and ease application of the concept, others[1] have raised concerns that it might increase the rigidity in the standards and facilitate opportunism (FASB, 2010).

[1] Some of the concerns raised in the comment letters regarding the indicators listed in paragraph 38 of IFRS 15 are that these indicators might be used as "a formulaic 'bright line' test that seems inappropriate to an otherwise principles-based and judgment-driven standard" (ED I-CL 114) and "as a checklist" (ED I-CL 614).

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