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The influence of process accountability and accounting standard type on auditor usage of a status quo heuristic

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A B S T R A C T

There has been considerable discussion about the U.S. reporting standards becoming less rules based, similar to International Financial Reporting Standards (IFRS). One proposed advantage of a change to IFRS is increased comparability across multinational and non-U.S. companies. Additionally, some believe that IFRS afford greater flexibility in its principles, thereby enabling firms' accounting choices to better reflect the true economic nature of any given transaction (FASB, 2002; SEC, 2003). With fewer rules, both financial statement preparers and auditors would be expected to adjust to having more options with regards to financial reporting. However, some proposed changes leave the option open to implement IFRS (or other principles-based standards) in ways that still follow rules in U.S. GAAP. This paper investigates whether prior year accounting treatments influence the judgment for current year treatments when one way to implement the standard is to follow the prior year treatment. We find that some auditors fixate on prior year scenarios and judgments, even if the current year scenario and applicable accounting standards are different. We find that holding auditors accountable for their decision making process reduces the likelihood of sticking with the prior year treatment most notably when the prior year standards were U.S. GAAP.

Introduction

Regulators in the United States have considered changing accounting standards for publicly traded companies to become more principles-based, either by changing to International Financial Reporting Standards (IFRS) or modifying current U.S. Generally Accepted Accounting Principles (GAAP) (SEC, 2010, 2011). The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have previously proposed several advantages to the U.S. moving to IFRS. One advantage of the proposed change is increased comparability across multinational and non-U.S. companies.[1] Additionally, IFRS is believed by some to have principles-based accounting standards that allow judgment in implementation that can

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[1] Soderstrom and Sun (2007) review the literature related to the adoption of IFRS in the European Union (EU) in 2005. They find that despite the fact that EU countries now use the same accounting standards, there are still differences in accounting quality across countries. Their review also suggests that firms listed in the U.S. who report under international standards are more likely to use accounting policies that are also acceptable under U.S. GAAP. Although there are differences in the regulatory environment, litigation environment, and other institutional factors in the U.S. compared to the EU, these findings provide some support that implementation of IFRS in the U.S. might not result in comparable financial statements across countries. Additionally, some countries use country-specific versions of IFRS (e.g., countries in the European Union report under IFRS "as adopted by EU"). To the extent that country specific versions of IFRS exist, cross-national comparability will remain compromised.

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enable the accounting to better reflect the true economic nature of any given transaction (FASB, 2002; SEC, 2003).

This judgment flexibility, however, can lead to recording transactions consistent with the current U.S. GAAP guidance (i.e., still following the GAAP "rule"), while simultaneously still following IFRS principles. For example, standards covering research and development (R&D) costs differ between IFRS and U.S. GAAP. Under current U.S. GAAP standards, research and development costs (except some software development costs) must be expensed (FASB Codification 730-10-05-3). However, under current IFRS standards, costs should first be classified as either research or development. Research costs are expensed immediately, but development costs are capitalized when technological and economic feasibility criteria are met (IAS 38). Given there is judgment involved in evaluating whether technological and economic feasibility criteria have been met, an auditor has the option of requiring the client to expense R&D costs under IFRS (which still follows the U.S. GAAP "rule"), or allowing for capitalization of R&D costs that meet the criteria for capitalization under IFRS. While allowing for either treatment under IFRS, the judgment is still to be applied based on how the auditor interprets the facts surrounding the economic event. Therefore, even after a move to more principles based standards, R&D transactions could still be recorded as they were under the more rules-based standard.[2] This study experimentally examines whether a status quo accounting treatment can reduce the full benefits of a transition to IFRS, or moving to more principles-based standards, due to the propensity to continue recording transactions consistent with rules prevailing in the current standards (U.S. GAAP), and whether process accountability reduces such a bias.[3]

Psychology literature has suggested that all else equal, individuals will rely on the status quo rather than modifying their behavior (e.g., Chernev, 2004; Hartman, Doane, & Woo, 1991; Johnson, Hershey, Meszaros, & Kunreuther, 1993; Kahneman, Knetsch, & Thaler, 1991; Lerner & Tetlock, 1999; Magee, 2009; Moshinsky & Bar-Hillel, 2010; Porter & Macintyre, 1984; Samuelson & Zeckhauser, 1988; Schweitzer, 1995; Tetlock, 1992; Tetlock & Boettger, 1994).[4] The desire to stay with the existing status quo is due to increased perceived risk in the new alternative that outweighs the disadvantages of staying with the existing position (Kahneman et al., 1991), which Curley, Yates, and Abrams (1986) characterize as ambiguity avoidance. In testing status quo effects, Tetlock and Boettger (1994) find that the desire to stay with the status quo is driven by the perceived risk of moving away from the status quo being larger than the perceived risk of staying with the status quo. While evaluating the risk in this way may seem like a reasonable approach, Tetlock and Boettger (1994) point out that one needs to be careful when making normative statements about status quo regarding whether it is a bias or viewed as a judgment error. They state that "the social contingency model raises questions about the normative baselines that we use in labeling response tendencies errors or biases" (Tetlock & Boettger, 1994, p. 2).[5]

Existing accounting literature has looked at various types of prior judgments and preferences impacting auditor judgment. O'Reilly, Leitch, and Wedell (2004) show that, in a series of independent judgments, auditors' prior judgments impact future judgments when evaluating the granting of loans. Their study was not about sticking with the status quo, but about the anchor being set impacting later judgments. Using case based reasoning, Salterio (1996) and Salterio and Koonce (1997) show that auditors use past precedents with similar facts to solve the current problem. Based on example based reasoning, Clor-Proell and Nelson (2007) also find that participants are likely to conclude that the current accounting treatment should be handled similar to an example that is provided when applying new accounting standards.

The objective of this study is to examine whether auditors exhibit a status quo heuristic (i.e., default more often to the status quo) when interpreting accounting standards, and whether creating a sense of process accountability in auditors can lessen reliance on this heuristic. Some existing psychology research has found that accountability can increase the propensity to stick with the status quo (e.g., Tetlock and Manstead, 1985; Lerner & Tetlock, 1999; Tetlock & Boettger, 1994). Some of the likely cause of accountability increasing status quo effects in the existing literature is that the findings of the aforementioned studies involve known audience preferences, socially accepted norms of behavior, and possible severe consequences. We expect process accountability to reduce the use of a status quo heuristic consistent with Samuelson and Zeckhauser (1988), as our audit setting does not involve any of those possible causes for an increase in status quo effects.[6] In order to realize the full benefits of switching to more principles-based standards, implementing additional accountability mechanisms might be necessary. Samuelson and Zeckhauser (1988) point out that there might not be a way to avoid status quo effects beyond having the decision maker consider all options available. Our

[2] Other examples include the option to write-up previously impaired inventory under IFRS and differences in the timing of revenue recognition under some contracts (Asay, Brown, Nelson, & Wilks, 2012).

[3] Although consistency across periods is generally a positive attribute of financial statements, defaulting to a prior treatment on a new transaction without considering differences in transactions and/or standards for the current period could lead to financial statement misstatements or lower financial statement quality.

[4] A review of the status quo research in psychology is presented in the next section of the paper.

[5] As we are not intending to make any normative statements regarding the role that the status quo plays in evaluating accounting treatments, we will refer to the status quo as being a heuristic. We thank an anonymous reviewer for this approach.

[6] Note that the design of our study does not indicate client preference to participants, although client preference is generally to increase net income (e.g., capitalize costs rather than expense them). We chose not to have the client preference or partner preference known to the participant, because known preference of the audience for a judgment is a condition that causes accountability to increase status quo effects. We examine whether process accountability can reduce status quo effects when the auditor is making a judgment prior to any known preference on the part of the client. Forming an independent judgment on the part of the auditor as to the proper accounting treatment avoids what Bazerman, Loewenstein, and Moore (2002) call approval bias. To the extent that explicit knowledge of client preference might change auditor decisions, this is a limitation of the current study.