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Matching between revenues and expenses and the adoption of International Financial Reporting Standards[☆]



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ABSTRACT

We examine changes in the matching between contemporaneous revenues and expenses in Australian financial reporting. Matching is fundamental to the economic demand for accrual accounting in preference to simple cash measures. Our results indicate that the revenue–expense relation has declined in Australia during 2001–2005, but improved following implementation of International Financial Reporting Standards (IFRS). The improvement is largely attributable to increases in the association of operating expenses and “other” expenses with contemporaneous revenues. These results are in sharp contrast to documented declines in matching among US firms, and also highlight a positive outcome associated with Australian firms’ mandatory adoption of IFRS.

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1. Introduction

The matching principle is arguably the most important theoretical underpinning for the traditional income statement approach to financial reporting. It requires the firm’s expenses to be recognized in the same period in which the revenues are earned. High quality matching between revenues and expenses is essential for reliable determination of firm profitability on a periodic basis.¹ Matching is therefore fundamental to the role played by accruals in modifying what would otherwise be cash flow reporting, so as to create a more

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¹ Dichev and Tang (2008) provide theoretical predictions and empirical evidence that the mismatch between revenues and expenses (poor matching) is likely to increase earnings volatility and decrease earnings persistence, implying lower quality of accounting information.

meaningful measure of periodic performance (Dechow, 1994). However, matching not only impacts on the extent to which accounting measures of income reflect performance, but is also fundamental to the governance role played by accounting measures of performance, such as the determination of monetary rewards linked to periodic performance. The more finite the measurement period, the more important matching of revenues and expenses becomes in establishing a meaningful performance measure.

Moreover, matching is expected to be fundamental to the broader quality of financial reporting. In their survey of CFOs, Dichev et al. (2013) find that the perceived neglect of the matching principle by accounting standard setters (in conjunction with increased emphasis on the reporting of fair values) is central to CFOs' expressed views that earnings quality is declining. Yet, as Dichev et al. (2013, p. 21) note, there is a "sparse research effort" addressing the extent to which matching is impacted by either economic circumstance or changes in accounting rules and regulations. Our research is intended to address this gap.

We examine the extent of matching between revenues and expenses for Australian firms between 1993 and 2011, paying particular attention to the period surrounding the mandatory adoption of International Financial Reporting Standards (IFRS). Our motivations are three-fold. First, understanding the level of and the trend in the extent of matching in Australia has important implications for financial statement analysis, the application of external financial reporting to governance roles such as measuring managerial performance, to accounting standard setting and further academic research. In the late 1970s, the Financial Accounting Standards Board (FASB) in the US abandoned the income statement approach (including the matching concept), adopting instead a balance-sheet approach, whereby the "proper" valuation of assets and liabilities is viewed as the primary goal of financial reporting. In contrast, the importance of matching has been continuously recognized in Australian statements of accounting concepts until the recent adoption of IFRS in 2005.² However, the FASB and the International Accounting Standard Board (IASB) appear to have moved further away from the income statement approach, with terms like "revenues", "expenses", "earnings" and "income" evidently kept to a minimum.³

The shift towards a balance-sheet approach has been highly controversial among practitioners and academics. Bezold (2009) argues that, under the balance-sheet approach, temporary value changes are incorporated into earnings information, resulting in erroneous volatility of earnings. Dichev (2008) maintains that the revenue–expense evaluation is heavily embedded in people's decision making processes spanning from investing (outside users) to management (inside users), while the balance-sheet approach fails to reflect this business reality.⁴ However, the extent to which the shift in standard-setter's focus from the income statement to the balance sheet impacts on matching is ultimately an empirical question. Our aim is to contribute to this debate by providing empirical evidence on changes in matching over an extended time period, including the mandatory switch to IFRS.

Second, our evidence also contributes to the limited data available suggesting a decline in matching elsewhere. Dichev and Tang (2008, DT) document a decline in matching between contemporaneous revenues and expenses for US firms over the past 40 years, and provide theoretical and empirical evidence that poor matching leads to lower quality of accounting information, such as higher earnings volatility and lower earnings persistence. They further indicate that a prolonged decline in matching appears mainly attributable to changes in the accounting standards. In contrast, Donelson et al. (2011) argue that the changes are primarily attributable to an increase in the incidence of large special items, and therefore conclude that changes in the economic environment, rather than changes in accounting standards, are primarily responsible for the decline in "matching". Finally, Srivastava (2011) examines a wider US sample that includes new listings and concludes that the decline in the revenue–expense association reflects dramatic increases in new listings. Given this mixed evidence focussing exclusively on US firm-years reporting under US GAAP, we believe that the examination of trends in matching in countries with accounting standards and economic circumstances that differ from the US is warranted.

² For example, the appendix of Australian Statement of Accounting Concepts 4 (SAC 4) states that "the reporting of relevant and reliable information about the profitability of a profit-seeking entity will typically involve the matching of revenues and expenses in an appropriate manner".

³ See FASB Statements of Financial Accounting Concepts No. 8.

⁴ Dichev (2008) proposes an alternative yet intuitive view on firms in general — a firm is an entity that continually advances expenses hoping to reap revenues and earnings. He argues that "the continual expansion of the balance sheet approach is gradually destroying the forward-looking usefulness of earnings, mainly through the effect of various asset revaluations, which manifest as noise in the process of generating normal operating earnings" (Dichev, 2008).

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