

**THE IMPACT OF REGULATORY ENFORCEMENT AND PRINCIPLES-  
BASED ACCOUNTING ON AUDITORS' JUDGMENTS TO CURB  
AGGRESSIVE REPORTING**

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# **The Impact of Regulatory Enforcement and Principles-based Accounting on Auditors' Judgments to Curb Aggressive Reporting**

**ABSTRACT:** With the movement towards International Financial Reporting Standards (IFRS) in the U.S., a question arises as to whether the worldwide adoption of a principles-based approach such as the IFRS will result in higher quality financial reporting. One widely cited factor that could potentially affect the implementation of a principles-based approach is the type of regulatory environment over financial reporting and auditing that is in place in a given country. Accordingly, the objective of this paper is to examine whether greater process accountability induced by a principles-based standard will lead auditors to become more focused on economic substance than a rules-based standard irrespective of the regulatory regime in place and will, thus, curb aggressive reporting. To examine this issue, we employ an experimental approach with 97 experienced auditors as participants. Using a case setting involving the classification of a lease (operating vs. capital), we manipulate the accounting standard as rules-based or principles-based and the strength of the regulatory enforcement regime as strong or weak. Results indicate that under either enforcement regime a principles-based standard results in less aggressive reporting. The implications of the findings for research and public policy are presented.

Keywords: Principles-based standards; Rules-based standards; Enforcement environment; Audit judgments; Leases; Public Policy.

# **The Impact of Regulatory Enforcement and Principles-based Accounting on Auditors' Judgments to Curb Aggressive Reporting**

## **INTRODUCTION**

There is considerable discussion and debate about the merits of principles versus rules-based accounting standards in the U.S. as the Securities and Exchange Commission (SEC) considers moving towards International Financial Reporting Standards (IFRS). A growing body of research suggests that principles-based accounting standards lead preparers to issue higher quality financial reports (Aglia, Douplik & Tsakumis, 2010; Jamal & Tan, 2010; Segovia, Arnold & Sutton, 2009). Notwithstanding these results, critics (e.g., Ball, 2006) argue that the ultimate impact of principles-based accounting standards on financial reporting quality is dependent on the strength of the regulatory enforcement mechanisms over financial reporting and auditing. This is especially relevant as we move towards IFRS-based accounting standards on a worldwide basis since the strength of such regulatory oversight could vary substantially from country to country. However, no prior study has examined the concurrent role of the type of accounting standards and the strength of the regulatory regime in order to understand the combined effects on the quality of financial reporting.

The purpose of the current study is to fill this gap by examining the joint effects of type of accounting standard (rules vs. principles)<sup>1</sup> and level of regulatory enforcement over financial reporting and auditing (weak vs. strong) on auditors' judgments with respect to an aggressive financial reporting stance adopted by the client's management. Thus, the public policy questions

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<sup>1</sup> In this paper, we define a principles-based standard as one that emphasizes the economic substance of a transaction while rules emphasize "bright lines" relating to what is stated in the standard. We recognize that in practice, the principles vs. rules comparison actually represents a continuum of how the standards are implemented. As noted by Bailey and Sawers (2011), "a rule-based accounting standard is one that contains specific guidelines, elaborate rules or clear thresholds ("bright-line") that tend to remove or reduce the level of judgment required to administer the standard, contain more scope and legacy exceptions, have excessive implementation guidance and excessive detail (SEC 2003)."

that this study attempts to address are: (1) How will auditors' judgments to constrain aggressive reporting be affected if a country such as the U.S. with its strong regulatory enforcement (Hail et al., 2010a; Jackson & Roe, 2009; La Porta, Lopez-de-Silanes & Shleifer, 2006; Webster & Thornton, 2005) were to change from a rules-based regime to a principles-based regime? (2) Will auditors' constrain aggressive reporting to a greater extent with the adoption of IFRS on a worldwide basis, despite varying levels of regulatory scrutiny in different countries, than that currently found under a rules-based, high regulatory scrutiny environment?

We focus on the first research issue because, despite the findings of recent research suggesting that principles-based standards enhance financial reporting quality (e.g., Agoglia et al., 2010; Jamal & Tan, 2010; Peytcheva & Wright, 2011), critics of IFRS adoption argue that, given the quality of U.S. GAAP and the presence of a strong enforcement regime and regulators such as the SEC and the PCAOB, IFRS would not incrementally improve reporting quality in the U.S. (Hail, Leuz & Wysocki, 2010a). We investigate the second issue because the strength of enforcement regimes varies greatly between countries, raising significant concerns about the relative quality of financial reporting with the adoption of IFRS worldwide. Some argue that reporting quality is only as good as the enforcement that is present (e.g., Ball, 2009; Holthausen, 2009), and that the advantages that prior research suggests may accrue from adopting principles-based standards could diminish or disappear under weak regulatory enforcement regimes.

In this study, we investigate auditor judgments in a situation in which preparers attempt to report aggressively. Our study is unique in that it examines auditors' judgments in constraining aggressive financial reporting by management in the face of two important factors: type of accounting standards and level of regulatory enforcement.<sup>2</sup> We investigate auditors' judgments,

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<sup>2</sup> Segovia et al. (2009) examine the level of concern of a regulator over a company's particular accounting practices (i.e., SEC expresses concern regarding potential investigation of the client's accounting practices), which is different

since it is widely recognized that the financial statements provided to the capital markets are the result of a negotiation or a resolution process between the auditor and management (Antle & Nalebuff, 1991; Brown & Wright, 2008; DeAngelo, 1981; Levitt, 1998; Wright & Wright, 1997). Thus, auditors may constrain aggressive reporting by management differentially in the face of rules versus principles-based accounting standards based on the level of regulatory enforcement.

We posit that the joint effects of type of accounting standard and strong enforcement regime will result in auditors constraining aggressive reporting by management to a greater extent for principles-based standards than for rules-based standards. Further, we expect that a principles-based standard in the face of varying strength of enforcement will still yield less aggressive reporting when compared to a rules-based standard even when the enforcement regime is strong. As will be discussed more fully, these hypotheses are consistent with enhanced process accountability under principles-based standards offsetting the potential impact of weak enforcement (Peytcheva & Wright, 2011). To examine these two issues, we employ an experimental approach using 97 experienced auditors as participants. The task setting entails the classification of a lease (operating lease or capital lease) where we manipulate accounting standard as either rules-based or principles-based and the strength of the regulatory enforcement regime as either strong or weak. Aggressive reporting in this context is defined as supporting the classification as an operating lease (i.e., off-balance sheet financing).<sup>3</sup>

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from the level of regulatory enforcement. Pomeroy (2010) examines the effect of regulatory scrutiny on auditors' resolution of material accounting issues, but holds the type of accounting standard constant.

<sup>3</sup> An SEC study concluded that bright lines "have served to facilitate significant structuring of leases to obtain particular financial reporting goals" (SEC, 2005) The study found that \$1.25 trillion of non-cancelable future cash obligations committed to operating leases are not recognized on the balance sheet, and concluded that bright-line standards "results in a clustering of lease arrangements such that their terms approach, but do not cross, the 'bright lines' in the accounting guidance that would require the lease to be recognized on the balance sheet" (SEC 2005)

The results indicate, as hypothesized, that when regulatory enforcement is strong, auditors constrain aggressive reporting to a greater extent in a principles-based regime than in a rules-based regime. We also find that auditors' judgments are more conservative under a principles-based environment, regardless of the strength of regulatory enforcement, compared with a rules-based regime accompanied by strong regulatory enforcement. This finding suggests that the process accountability induced by principles-based standards is a significant factor in promoting improved reporting (Peytcheva & Wright, 2011). The public policy implication of these findings is that adopting a principles-based approach to standard setting could potentially result in higher quality financial reporting in developed markets such as the U.S. as well as in markets where the regulatory regimes are not as strong such as those found in less-developed countries. Further, these results suggest that the SEC's policy of accepting financial statements prepared from foreign registrants under IFRS may not diminish the quality of the financial reports to potential investors. Our findings are also consistent with Peecher, Solomon & Trotman (2010) who argue that auditors' judgments are more likely to be improved by holding auditors accountable for the quality of their decision process (i.e., process accountability) as opposed to holding them accountable for audit outcomes and financial-statement outcomes (i.e., outcome accountability).

The remainder of the paper is divided into four sections. The next section provides a review of relevant literature and development of the research hypotheses. This section is followed by a description of the method and presentation of the findings. The final section is devoted to a discussion of the major findings and their implications for future research and public policy.

## **LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

Standards that contain bright-lines may allow preparers to structure transactions in order to meet financial reporting objectives and may thus encourage a "check-the-box" approach

(Schipper, 2003). Conversely, when standards are based on broad principles, preparers may be subject to the greater burden of matching reporting choices to the economic substance of transactions. Thus, a rules-based approach has the potential to result in a more aggressive financial reporting behavior which could ultimately lower the quality of the financial reporting process. For example, Agoglia et al. (2010) find that financial statement preparers are more likely to report aggressively under rules-based than under principles-based standards. Further, when standards are rules-based, preparers are less likely to report aggressively with a strong audit committee than with a weak audit committee; this effect is not observed under principles-based standards. However, that study looked at an internal enforcement mechanism and not the external enforcement regime in place where the company is domiciled. Using an instrument to measure the extent to which U.S. accounting standards contain rules-based characteristics, and selecting a sample of accounting irregularities in U.S. companies, Mergenthaler (2009) finds that the magnitude of earnings management is greater in rules-based standards than under principles-based standards. Jamal and Tan (2010) show that preparers report less aggressively under principles-based standards, but only if the auditor is principles-oriented, as opposed to client-oriented or rules-oriented. This highlights the importance of considering monitoring factors that may differentially influence auditors under a principles-based regime as opposed to a rules-based regime. Finally, Segovia et al. (2009) find that auditors are more willing to allow clients to manage earnings under a more rules-based standard (SFAS 121) than under a more principles-based standard (ARB 43).

Previous research has studied how different standards influence auditors' response to aggressive reporting by clients. Some studies suggest that less-precise, more principles-based standards will result in greater auditor concessions to management, resulting in more aggressive

reporting.<sup>4</sup> For example, Nelson (2003) discusses the possibility that less-precise accounting standards might make it more difficult for auditors to disallow client-preferred treatments and might thereby lead to more aggressive reporting. Further, Trompeter (1994) finds that audit partners are more likely to allow income-increasing accounting alternatives when standards are less precise. Ng and Tan (2003) show that the absence of precise authoritative guidance increases auditors' concessions to client demands, but a strong audit committee reduces this effect. Moreover, Nelson, Elliott & Tarpley (2002) find that auditors are less likely to constrain earnings management attempts that use structured transactions when the accounting standard provides detailed, bright-line guidance.

All of the aforementioned studies were conducted pre-SOX, and post-SOX the auditing profession and corporate governance mechanisms have been working to improve the quality of the financial reporting process. For example, the auditing profession recently has expressed strong support for principles-based standards that would allow auditors more room for judgment regarding the faithful representation of economic reality (AICPA, 2007; DiPiazza, McDonnell, Samyn, Flynn, Quigley & Turley, 2008). Increased room for judgment is likely to increase the extent to which auditors perceive themselves accountable for the quality of their judgment and decision making processes (Peytcheva & Wright, 2011). In this paper, we examine the effect of accounting standards on audit judgment through the lens of accountability theory.

Peytcheva and Wright (2011) examine the effect of different accounting standards on auditors' perceptions of process accountability, and find that principles-based standards increase both process accountability and epistemic motivation among auditors relative to rules-based

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<sup>4</sup> We view principles-based standards similarly to less-precise standards because, as explained by Jamal and Tan (2010), they possess few bright-line tests. In contrast, as discussed by Nelson (2003), rules-based standards "include specific criteria, "bright-line" thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidance, etc."

standards. Epistemic motivation is the desire to obtain a thorough and accurate understanding of the issue at hand (De Dreu, Beersma, Stroebe & Euwema, 2006; Kruglanski, 1989). The high levels of epistemic motivation induced by principles-based standards are then found to improve auditor decision performance. Process accountability has been shown to increase epistemic motivation in negotiations (Scholten, Knippenberg, Nijstad & De Dreu, 2007; Van der Schalk, Beersma, van Kleef & De Dreu, 2009) and in cognitive tasks (Bodenhausen, Macrae & Hugenberg, 2003; De Dreu et al., 2006). High epistemic motivation has been found to stimulate decision makers to search for “the truth” because of concerns about possible invalidity of their judgment (Freund, Kruglanski & Schpitzajzen, 1985; Kruglanski, 1989). In a similar vein, Backof, Bamber & Carpenter (2010) examine the effects of different judgment frameworks under IFRS and find that auditors’ decision quality is highest under a judgment framework which induces a deliberative mindset, urging auditors to focus on the “why” of the transaction and to determine objectively the accounting method that best reflects the economic substance of the transaction.

Accountability theory suggests that increased perceptions of accountability for the process used to reach a decision, as opposed to accountability for the outcome itself, improves judgment quality (Lerner & Tetlock, 1999; Siegel-Jacobs & Yates, 1996; Tetlock, 1983). In auditing, greater levels of process accountability have been shown to increase audit effort (Kennedy, 1995) and to improve judgment accuracy (Ashton, 1992). Peecher et al. (2010) propose that the judgment of external auditors can be incrementally improved by increased levels of process accountability.

This study focuses on the policy issues of how principles-based standards affect auditors’ ability to curb aggressive reporting under regulatory enforcement regimes of different strength.

Regulatory enforcement over financial reporting and auditing provides the infrastructure within which preparer and audit judgments are made. For instance, in the United States the primary regulatory agencies that oversee financial reporting and auditing are the SEC and the PCAOB. Many have expressed concerns that, because the strength of enforcement regimes varies greatly between countries, IFRS adoption will ultimately lead to significant variations in financial reporting quality worldwide (e.g., Ball, 2009; Hail et al., 2010a; Hail, Leuz & Wysocki, 2010b; Holthausen, 2009). Further, some have argued that regulatory enforcement regime, and not the type of accounting standard, is the primary determinant of financial reporting quality (see Hail et al., 2010a for a review).

Holding the type of accounting standard constant, Pomeroy (2010) finds that when regulatory scrutiny is high, accountability demands to regulators dominate auditors' responses and thereby reduce reporting quality. In an archival study across 42 countries, Francis and Wang (2008) examine the effect of investor protection regime on earnings quality. Guided by the framework in La Porta et al. (2006; 1998), that study considers investor protection regime to be composed of several unique variables, including the strength of public regulatory enforcement, legal regime and corporate laws. The study finds conditional results: earnings quality increases as investor protection regimes become stronger, but only for clients of the Big 4 audit firms. Further, for clients of Big 4 firms, the effect of public regulatory enforcement regime is not significant for two of the three measures of earnings quality.

It is important to note that aggressive reporting can occur in different ways. For example, management can commit fraud, or they can structure accounting transactions so that the transaction meets the "letter" but not the "spirit" of the standard (Nelson, 2003; Nelson et al., 2002). In this paper, we do not focus on the judgment of auditors in situations where

management has committed fraud, or reports are in blatant violation of the accounting standard. Such situations are relatively rare, and the auditor's role in curbing such behavior is clear (SAS 99). We examine auditors' judgments to constrain aggressive reporting when management has structured the accounting transaction to strictly comply with the rule, but in a scenario where management's reporting treatment does not reflect the economic substance of the transaction.

When accounting standards are rules-based, and managers report aggressively by structuring transactions to meet the bright-line of the accounting rule, it is not clear that a strong regulatory enforcement regime will punish managers, since they are complying with the bright-line of the rule (Nelson, 2003; Nelson et al., 2002). For instance, although the SEC has expressed concerns that in the U.S. companies can exploit rules-based standards for aggressive reporting through financial engineering, little is done to overturn such reporting, given that it is engineered to comply with the bright-lines of the standard (CIFIr, 2008; SEC, 2008). The SEC has debated the shortfalls of bright-lines; for instance, it purposefully stayed away from implementing a bright-line rule for materiality in Regulation FD (SEC, 2000). The Commission acknowledged that, although this would make judgments more difficult, it is not appropriate to adopt a bright-line rule in response to difficulty in judgment, and further explained that it would be impossible for a bright-line standard to address adequately the variety of situations that may arise (SEC, 2000). In light of this discussion, it is an open question whether increased strength of regulatory enforcement would be able to curb aggressive reporting achieved through financial engineering under rules-based accounting standards.

### **Impact of principles-based standards under strong regulatory enforcement**

An examination of the effect of accounting standards under strong regulatory enforcement is particularly important as the U.S. considers transitioning from a rules-based accounting standard

to a principles-based accounting standard such as the IFRS. As Hail et al. (2010a) state: “the intensity of public enforcement efforts in the United States is unparalleled in the world, not just in terms of rules and regulation (La Porta et al., 2006), regulators’ staffing levels and budgets (Jackson & Roe, 2009), but even more so in terms of actual enforcement actions and sanctions imposed (Coffee, 2007).” Thus, we focus on the following public policy issue:

***How will auditors’ judgments to constrain aggressive reporting be affected if the U.S. with its strong regulator enforcement were to change from a rules-based regime to a principles-based regime?***

Prior research has confirmed a theoretical model for effect of standard type on auditors’ accountability perceptions. Peytcheva and Wright (2011) find that auditors experience high process accountability and epistemic motivation under principles-based standards, and this leads auditors to make judgments that are more consistent with economic substance. Collectively, the literature on the motivational and cognitive effects of process accountability suggests that the greater freedom of judgment and sense of accountability under principles-based standards will increase the likelihood that auditors will focus on the substance of the economic transaction, and hence constrain management’s aggressive reporting under principles-based standards relative to rules-based standards (Peecher et al., 2010; Peytcheva & Wright, 2011; Tetlock, 1983). We therefore expect that auditors will perceive themselves highly accountable for their judgments under principles-based standards, and this will lead them to curb aggressive reporting by management relative to rules-based standards.

Previous research has found that auditors have incentives to please their clients (Hackenbrack & Nelson, 1996; Kadous, Kennedy & Peecher, 2003; Salterio & Koonce, 1997; Trompeter, 1994), and that decisions to comply with client preferences are consistent with the literature on motivated reasoning (Kunda, 1990). Client pressures, therefore, are expected to increase the

likelihood that auditors will allow the client-preferred treatment when this decision will not be subject to strong regulatory enforcement.

When regulatory enforcement is strong, the tradeoff between yielding to client pressures and avoiding regulatory sanctions will become more pronounced. One could expect the high level of scrutiny of strong regulatory oversight to lead to some improvements in auditor judgment under a rules-based regime. However, given a situation where a client has structured the transaction to meet all bright lines in the standard, the client's position is strengthened by complying with the letter of the law.

As noted previously, contentious reporting matters between management and the auditor are often resolved through a negotiation process (Bame-Aldred & Kida, 2006; Brown & Johnstone, 2009; Gibbins, Salterio & Webb, 2001). Thus, in a bright line, rules-based environment if the client structures a transaction to comply with the rules but the auditor believes the economic substance of the transaction is not reflected, the auditor has little bargaining power in confronting the client knowing that regulators are unlikely to support their position and penalize management (Agoglia et al., 2010; Weil, 2002). Prior negotiations research has demonstrated that bargaining power has a significant impact on negotiation tactics and outcomes (e. g., Gruder, 1971; Kahan, 1968; McGrath, 1966; Savage, Blair & Sorensen, 1989). If auditors perceive that they have little power in their negotiations, they are less likely to be resolute in their insistence on less aggressive reporting (Brown & Wright, 2008). In contrast, in a principles-based regime, high regulatory enforcement is likely to focus on broad guidelines and the proper reporting of the economic substance of a transaction. In such an environment, a principles-based regime combined with high regulatory enforcement is likely to strengthen the auditor's

negotiation position (Brown and Wright 2008) with the client because the likelihood of sanctions against GAAP violations increases.

The discussion above leads us to the following hypothesis.

***H1:*** When regulatory enforcement is strong, auditors are more likely to constrain aggressive reporting by management in a principles-based accounting regime than in a rules-based accounting regime.

### **Principles-based environment with variations in strength of regulatory enforcement**

The potential benefits of the adoption of principles-based standards such as IFRS on a worldwide basis have been presented as a significant argument in favor of the U.S. adoption of IFRS. However, Ball (2006) cautions that principles-based standards are likely to be enforced differently across different regulatory environments. The AICPA (2007) argues that if IFRS are to become a reality in the US, it is essential to consider how the current regulatory environment would interact with these standards. For example, Holthausen (2009) and Ball (2009) argue that the strength of regulatory enforcement would ultimately determine the effect of IFRS on financial reporting outcomes. Holthausen (2009) goes on to suggest that other factors, such as the quality of the audit, are likely to jointly affect financial reporting outcomes across different accounting standards and levels of regulatory enforcement. Hence, from a public policy perspective, we examine the following important issue:

***Will auditors' constrain aggressive reporting to a greater extent with the adoption of IFRS on a worldwide basis, despite varying levels of regulatory scrutiny in different countries, than currently found under a rules-based, high regulatory scrutiny environment such as in the U.S.?***

Examining this issue in the paradigm of process accountability theory involves considering whether the increased accountability perceptions that stem from principles-based standards (Peytcheva & Wright, 2011) would be negated in the presence of regulatory regimes of varying

strength. We expect that principles-based standards would exert an accountability effect on auditors regardless of the level of regulatory enforcement. In making auditors feel more accountable for their judgments, principles-based standards may substitute for the lower accountability potentially brought about by weaker regulatory enforcement. Further, as recently discussed by Peecher et al. (2010), regulators at least in the US mainly focus on making auditors accountable for the outcome of their decisions. Instead, drawing on the extensive research that highlights the positive effects of process accountability, Peecher et al. (2010) propose that auditor decisions will be improved by increased *process* accountability rather than outcome accountability.

Our theoretical expectation is also indirectly supported by the empirical findings of prior research. Segovia et al. (2009) find that auditors are less likely to allow earnings management by clients under principles-based versus rules-based standards, and that the effect of standard type on auditor judgment overwhelms the effect of a possible SEC investigation of the client. In an archival study, Webster and Thornton (2005) examine Canadian firms cross-listed in the US, and thus reporting under both US and Canadian accounting standards. They find a higher accruals quality for firms under the stronger US oversight. The study, however, finds no difference between Canadian firms using Canadian GAAP and US firms using US GAAP. The study's findings suggest that the quality of accruals is jointly determined by accounting standards and enforcement. However, because Webster and Thornton (2005) use an archival methodology, they cannot disentangle the effect of regulatory oversight from the effect of the litigation environment and other country-specific factors. Further, the study finds no difference in financial reporting quality between principles-based accounting standards within a weaker regulatory regime and rules-based accounting standards within a stronger regulatory regime. This finding suggests that

principles-based accounting standards, under either a weak or a strong regulatory enforcement regime, will result in financial reporting quality that is at least as high, if not higher, than rules-based standards under a strong regulatory enforcement regime.

Collectively, these empirical findings support our prediction that principles-based standards are likely to compensate for the effect of enforcement mechanisms. This leads to the following hypothesis:

**H2:** Auditors' propensity to constrain aggressive reporting will be greater in a principles-based regime, regardless of strength of the regulatory enforcement, than in a rules-based accounting regime with strong regulatory enforcement.

## METHOD

### Experimental Design

To address the research hypotheses we conduct an experiment with a 2x2 between-subjects factorial design, with the following independent variables: accounting standard type (principles-based versus rules-based) and regulatory enforcement regime (strong versus weak). The dependent variable is auditors' expectation about the final classification of a lease as either a capital lease or an operating lease.

### Participants and Task

Participants in the study were 97 auditors (62 male and 35 female) from a Big 4 audit firm, with a mean (median) of 6.7 (5) years of audit experience. Participants were 55 audit seniors, 36 audit managers, and 6 audit partners.<sup>5</sup> Approximately 35 percent of the auditors had participated in IFRS engagements, and 29 percent had audited public companies domiciled outside the US (excluding subsidiaries of US public companies). Participants had encountered the issue of

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<sup>5</sup> As discussed in the results section, there were no differences in the results based on the experience level of the auditors.

accounting for leases, the task setting of the experiment, an average of 7.6 times during their careers. In all, the demographic profile of the auditors indicates that our participants had appropriate domain and task specific experience (Abdolmohammadi, 1999; Bedard & Biggs, 1991).

Participants completed the study in a training session conducted on the firm's premises. The study was introduced by an audit partner, who expressed the firm's support for the research and encouraged participation. After providing informed consent, participants completed the experimental materials and answered demographic questions. The experimental task consisted of examining a lease scenario involving a hypothetical company and then determining the classification of the lease as an operating lease or a capital lease. Although there are potential changes in accounting for leases (FASB, 2010a)<sup>6</sup>, the lease standard remains an appropriate setting illustrating the differences between principles- and rules-based standards. Further, the lease context enhances the comparability of our findings with those of prior studies, since leases have been used extensively in prior research to study the effects of principles versus rules-based standards on financial reporting quality (Agoglia et al., 2010; Backof et al., 2010; Grenier, Pomeroy & Stern, 2010; Jamal & Tan, 2010).<sup>7</sup> The task was adapted from Peytcheva and Wright (2011) which had been pilot-tested with four audit partners who were experts on lease accounting. The case was designed so that the normative lease classification, based on the economic substance of the transaction, is a capital lease. The terms of the length of the lease were for a major part of the asset's life (74%), although the numbers fell just below the thresholds in the rules-based lease standard (80%). Similarly, the present value of the lease

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<sup>6</sup> There has also been some backing away of the requirement of capitalizing all leases as companies have stepped up pressure to keep some leases in the noncapital category (Whitehouse, 2011).

<sup>7</sup> Moreover, findings from prior research on principles-based vs. rules-based accounting standards suggest that results using a lease setting can be generalized to other accounting settings (Bailey & Sawers, 2011).

payments was high vis-à-vis the fair market value of the asset (77%) but fell just below the threshold in the rules-based standard (80%). The case narrative emphasized the economic importance of the leased asset to the client firm: by explaining that the company would use the lease as a major production facility for two new product lines and discussed the client company's plans for moving production of three other successful product lines to the premises. It was also highlighted that historically the company had been renewing all previous leases from the lessor at the end of the contracted terms, thus suggesting that the current lease transaction is in essence a financing one. It was also emphasized that, because of a restrictive debt covenant, the client's management had incentives to prefer the transaction be classified as an operating lease. The normative classification of the transaction as a capital lease was confirmed by all pilot-test participants, whose suggestions were also included in the experimental materials. Participants read that the client firm's management had classified the transaction as an operating lease.

## **Independent Variables**

### *Accounting Standard*

Accounting standard was manipulated at two levels: principles-based or rules-based. The manipulation is based on that used in Peytcheva and Wright (2011) as shown in Panel A of Exhibit 1. While in reality the types of accounting standards can span a broad continuum (Bailey & Sawers, 2011), in our experiment we have focused on the polar ends of this continuum, in order to increase the strength of the experimental manipulations. The principles-based standard explained that the lease should be classified based on the degree to which it transfers the risks and rewards incidental to ownership, similar to the actual wording of IAS 17. The rules-based

standard listed three criteria as bright-line thresholds for classification as a capital lease.<sup>8</sup> The prescriptive wording of the standard was closely modeled after the wording of SFAS 13.<sup>9</sup> However, in order to prevent auditors from automatically reverting to a US-GAAP frame of reference, we used numeric thresholds different from the ones in SFAS 13 for the rules-based standard condition.

### *Regulatory Enforcement Regime*

The manipulation of regulatory enforcement regime was based on the framework developed in La Porta et al. (2006). Regulatory enforcement regime was manipulated at two levels: strong or weak. In the strong condition, the principal regulatory agency, “Investor Oversight Board” (IOB), was described as: (1) having the ultimate investigative powers to command documents and subpoena the testimony of witnesses when investigating violations of securities laws; (2) having the power and having used this power to order the public accountant to perform or desist from performing specific actions to rectify the violation of securities laws resulting from the issuance of misstated financial statements or for violations of auditing standards; and (3) having the power and having used this power to hold the public accountant criminally liable when the financial statements of the company are materially misstated. In the weak condition, the IOB was described as: (1) having the power to command documents and subpoena the testimony of witnesses when investigating violation of securities laws, but only with the prior approval of other government authorities which was not always granted; (2) not having the power to order

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<sup>8</sup> The FASB Conceptual Framework, developed jointly with the IASB, focuses on decision-useful information, and suggests that financial information should reflect the economic substance of transactions, rather than simply comply with the rules (FASB, 2006; 2010b). Thus, auditors can elect to curb aggressive reporting even under a rules-based standard, in order to provide a “faithful representation of the real world economic phenomena” (FASB, 2006).

<sup>9</sup> Specifically, the wording: “If a lease meets any of the criteria specified below, it is to be recorded as a capital lease; otherwise it is to be accounted for as an operating lease” was modeled after the following prescriptive wording in SFAS 13: “If at its inception a lease meets any of the four lease classification criteria in paragraph 840-10-25-1, the lease shall be classified by the lessee as a capital lease. If none of the four criteria in paragraph 840-10-25-1 are met, the lease shall be classified by the lessee as an operating lease.”

the public accountant to perform or desist from performing specific actions to rectify the violation of securities laws resulting from the issuance of misstated financial statements or for violations of auditing standards; and (3) not having the power to hold the public accountant criminally liable when the financial statements of the company are materially misstated. The qualities of the regulator, and their descriptions, mimicked the framework of La Porta et al. (2006).

Finally, in order to keep the strength of legal regime constant across conditions, the case materials included the following text in all experimental conditions: “Although the legal and court systems in Country X are considered reasonably efficient, the litigation risk from investors and the related liability to the accounting profession is considered moderate (i.e., neither too high nor too low when compared to the United States).” This was also done in order to avoid confounding litigation risk with the strength of regulatory enforcement over financial reporting and auditing.

[insert Exhibit 1 here].

### **Dependent Variable**

As discussed previously, the final reporting outcome is a joint resolution process between the client and the auditor, reflecting the relative bargaining power, accountabilities (i.e., investors, the client, and regulatory enforcement bodies), and incentives of each party. Consistent with Ng and Tan (2003), we therefore measure the auditor’s expected outcome of the lease classification. Participants’ perceptions of the final classification of the lease were measured with the question “How likely is it that the final accounting treatment of the transaction will be to classify it as an operating lease?” Answers were recorded on a 7-point Likert scale (1 = not likely, 7 = very likely). As mentioned earlier, Peytcheva and Wright (2011) pilot-tested the case with experts on

lease accounting, all of whom confirmed the normative classification of the transaction as a capital lease. Since normatively the lease should be reported as a capital lease and not an operating lease, higher values therefore indicate more aggressive reporting.

## RESULTS

### Manipulation Checks and Covariates

One participant did not provide responses to the questions included in our main analyses, and therefore the main analyses are conducted with a sample of 96 auditors. The effectiveness of the experimental manipulation for type of accounting standard was assessed by comparing participants' responses to the statement: "The accounting standard followed by ABC was based on (1 = detailed rules, 7 = broad principles)." Participants in the principles-based condition perceived that the standard was based on broad principles (mean of 5.70) to a greater extent than participants in the rules-based condition (mean of 2.94), indicating that our manipulation of accounting standard type was successful ( $t = 7.76, p < 0.001$ ). The effectiveness of the manipulation for regulatory enforcement strength was tested by comparing participants' ratings of the statement: "The power of the IOB in overseeing the accounting profession is (1 = very weak, 7 = very strong)." Participants in the strong regulatory enforcement condition rated the IOB power as significantly greater (mean of 5.53) than participants in the weak regulatory enforcement condition (mean of 2.96), indicating success of the manipulation of enforcement strength ( $t = 10.16, p < 0.001$ ).<sup>10</sup>

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<sup>10</sup> Five participants provided end-of-scale responses in a direction opposite to that of the manipulation for one or both manipulation check questions. Excluding these five participants from our analyses does not qualitatively change our results.

None of the demographic items collected (experience, position in the firm, gender, times leases encountered, number of IFRS engagements, number of clients domiciled outside the US) were significant when included as covariates in the analyses (all  $p > 0.33$ ).

## **Hypotheses Tests**

### *Hypothesis 1*

Descriptive statistics for the auditor-assessed *expected final lease classification* are shown in Table 1. As stated previously, since this variable is measured by participants' responses to the question how likely is it that the final accounting treatment of the transaction will be to classify it as an operating lease (1 = not likely, 7 = very likely), a higher mean score indicates more aggressive financial reporting.

[insert Table 1 here]

Participants in the principles-based condition report it is less likely that the final classification of the lease will be an operating lease (mean of 4.10) than do participants in the rules-based condition (mean of 5.40), i.e., less aggressive reporting under principles-based standards. Results from an ANOVA, displayed in Panel A of Table 2, show a significant main effect for type of accounting standard ( $F_{1,92} = 19.31, p < 0.01$ ), confirming results from prior research findings that principles-based standards improve auditors' decision performance relative to rules-based standards (Peytcheva & Wright, 2011). We also find a marginally significant interaction between type of accounting standard and strength of regulatory enforcement ( $F=3.66, p=0.06$ ).<sup>11</sup>

[insert Table 2 here]

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<sup>11</sup> Regression analysis yields results that are both qualitatively and quantitatively similar to the ANOVA. The model is significant ( $F = 7.79, p < 0.01$ ). The coefficient on accounting standard is -1.88 (p-value of 0.01, one-tailed), the coefficient on regulatory enforcement regime is -0.37 (p-value of 0.20, one-tailed), and the interaction coefficient is 1.14 (p-value of 0.06, two-tailed).

H1 proposed that when regulatory enforcement is strong, auditors' propensity to constrain aggressive reporting by management will be greater in a principles-based accounting regime than in a rules-based accounting regime. We examine this hypothesis by conducting a planned contrast test and expect that the mean of the variable *expected final lease classification* will be significantly lower (less aggressive) in the principles-based standards, strong regulatory enforcement regime condition than under rules-based standards, strong regulatory enforcement regime condition. Table 1 shows that the mean *expected final lease classification* is 4.48 in the principles, strong regulatory enforcement condition and 5.22 in the rules, strong regulatory enforcement condition. Results from the planned contrast test, presented in Panel B of Table 2, indicate that this difference is significant ( $t_{46} = -1.82$ ,  $p < 0.04$ , one-tailed), providing support for H1.

### *Hypothesis 2*

H2 proposed that auditors' propensity to constrain aggressive reporting will be higher in a principles-based regime, regardless of the strength of the regulatory enforcement, than in a rules-based accounting regime with a high level of regulatory enforcement (as the current environment in the US is often described). In essence, this hypothesis examines whether financial reporting quality under a principles-based approach with likely varying strength of enforcement across countries results, nonetheless, in less aggressive reporting than the current rules-based system that is coupled with strong regulatory enforcement. To test this hypothesis, we perform a planned contrast test, comparing the mean of the variable *expected final lease classification* for principles-based standards across both regulatory regime conditions (i.e., strong and weak regulatory enforcement) to the rules-based standard, strong regulatory enforcement condition. The mean *expected final lease classification* for principles-based standards across enforcement

conditions is 4.10, while the mean for the rules-based standard and strong enforcement condition is 5.22 (Table 1). Results from the planned contrast test, shown in Table 2, Panel B, provide support for H2 ( $t_{70} = -2.94$ ,  $p < 0.01$ , one-tailed).

### **Additional Analysis**

Additional analysis shows that auditors constrain aggressive reporting more under principles-based standards and weak regulatory enforcement than under (a) rules-based standards and strong regulatory enforcement ( $t = -3.49$ , two-tailed  $p < 0.01$ ), and (b) rules-based standards and weak regulatory enforcement ( $t = -4.30$ , two-tailed  $p < 0.01$ ). We also find that auditors constrain aggressive reporting more effectively under principles-based standards and strong regulatory enforcement than under rules-based standards under a weak regulatory enforcement regime ( $t = -2.7$ , two-tailed  $p < 0.01$ ). Finally, somewhat unexpectedly, we observe that in a principles-based standards regime, auditors curb aggressive reporting more under weak regulatory enforcement than under strong regulatory enforcement ( $t = -2.05$ , two-tailed  $p < 0.05$ ). As discussed more fully in the discussion section, this unexpected finding could be a function of the greater role that the auditors place on themselves or because of auditors' expectations of demands placed upon them by the audit committee when enforcement varies in a principles environment.

Since financial reporting quality is predicated on the joint product of the client's reported results and the auditor's position, our primary analyses focused on the auditor-assessed final classification of the lease. However, we also examine in an untabulated analysis auditors' preferred classification decisions. Auditors' preferred lease classification was measured with the question "How do you think the lease should be classified?", allowing participants to select one of two choices: capital lease or operating lease. Participants' responses to this indicator variable were coded 1 for capital lease and zero otherwise. We find that in the principles-based condition,

22 (27) participants classify the lease as a capital (operating) lease, in contrast to the 7 (40) participants who do so in the rules-based condition. Results from a logistic regression including the effects of both independent variables as well as their interaction indicate that principles-based accounting standards increase the likelihood that auditors will prefer to classify the lease as a capital lease ( $p < 0.01$ ), while the effects of regulatory enforcement regime and the interaction are insignificant ( $p$ -values of 0.64 and 0.26, respectively).<sup>12</sup>

## SUMMARY AND DISCUSSION

The debate over the relative merits of principles vs. rules-based accounting standards has drawn considerable attention from regulators, standard-setters, and the accounting profession (DiPiazza et al., 2008). Research on the effects of a principles-based accounting regime on financial reporting quality has started to emerge, as practitioners and academics strive to understand the potential consequences of moving to a principles-based standard under IFRS. An emerging stream of research generally suggests that from both a preparer and auditor perspective a principles-based accounting regime is likely to result in higher quality financial reporting (Agoglia et al., 2010; Jamal & Tan, 2010; Peytcheva & Wright, 2011). However, some regulators and academics argue that the effect of type of accounting standard on financial reporting quality cannot be studied without consideration of the regulatory enforcement regime over financial reporting and auditing within which such standards will be implemented and practiced (Ball 2006). This study attempts to address that gap.

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<sup>12</sup> We also examined whether type of standard or regulatory enforcement regime affects participants' expectation of a difference between their preferred lease classification (categorical variable) and the expected final classification of the lease (measured on a 7-point Likert scale), i.e., whether the final resolution would countermine their preferred position. Our analysis reveals that such instances are (a) small in number, (b) distributed across conditions, and (c) not affected by accounting standard type or regulatory enforcement regime.

Consistent with prior research focusing on financial statement preparers (e.g., Agoglia et al., 2010; Jamal & Tan, 2010), we find that auditors' judgments under principles-based standards significantly enhance financial reporting quality when compared to rules-based standards. Specifically, we find that when regulatory enforcement is strong, auditors constrain aggressive reporting to a greater extent in a principles-based regime than in a rules-based regime. As further evidence of the dominant effect of principles-based accounting standards on auditors' judgments, we find that auditors constrain aggressive reporting by management to a greater extent under a principles-based environment irrespective of the strength of regulatory enforcement, than when compared with a rules-based regime operating under a strong regulatory enforcement.

These results have important implications for regulation and policy, audit practice, and future academic research. The SEC is considering the adoption of IFRS for U.S. public companies and is slated to make its final decision in 2011. An important issue for regulators to consider is the potential impact the adoption of IFRS will have on auditors' judgments and consequently on the quality of financial reporting. The results of our study suggest that when regulatory enforcement is strong, auditors are more likely to constrain aggressive reporting under a principles-based regime such as the one proposed under IFRS, than under the rule-based regime that is currently present in the U.S. Further, regulators and others have raised serious concerns over the implementation of IFRS across different countries with differing regulatory standards. Ball (2006, 16) states: "Does anyone seriously believe that implementation will be of equal standard in all the nearly 100 countries...that have announced adoption of IFRS in one way or another?" Ball (2006) argues that monitoring mechanisms, including regulatory enforcement, operate differently across countries and that variability in monitoring mechanisms can result in substantial differences in financial reporting quality under IFRS. The results of our

study suggest that auditors are more likely to curb aggressive reporting under principles-based standards than under rules-based standards regardless of the strength of the regulatory regime in place, thus implying that the differential effects of regulatory regimes on financial reporting quality may be less pronounced in a principles-based regime under IFRS.

Our results also have important implications for audit practice. The findings suggest that auditors' judgments under a principles-based regime will be more likely to curb aggressive reporting by management than under the current rules-based regime. Critics of IFRS have argued that a move towards a principles-based accounting standard such as IFRS is likely to result in lower quality financial reporting since it affords greater latitude to preparers and auditors of financial information with respect to the interpretation and application of accounting standards (Investor perspectives on IFRS implementation, 2007; Niemeier, 2008). The results of this study, in conjunction with prior studies that have examined the effect of principles-based standards on preparers of financial statements (e.g., Agoglia et al. 2010; Jamal and Tan 2010), suggest that both preparers and auditors are likely to make less aggressive accounting judgments, potentially resulting in higher quality financial reporting. This further strengthens the public policy implications of the desirability of switching to a principles-based standard system.

One unexpected result is that participants in the principles-based weak enforcement regime were significantly more likely to curb aggressive reporting than participants in the principles and strong enforcement regime. A plausible explanation for this is that auditors act as gatekeepers over the quality of the financial reporting process (Cohen, Krishnamoorthy & Wright, 2004). Thus, in a weak regulatory regime, auditors may perceive that they have to take a greater role to insist on curbing aggressive reporting. Further, the result could also be a function of the perceived expectations that audit committees will place on auditors. For example, in a

weak regulatory environment, the audit committee may be viewed as counting on the auditor to curb aggressive reporting as they have little faith that a regulatory body will deter management. A future study could look at how the orientation and expectations of the audit committee may induce auditors to act differently under alternative reporting mechanisms. Other promising avenues for future research include studying the joint effect of accounting standard type and the litigation environment on auditors' judgments to constrain aggressive reporting, or examining how the magnitude of client pressures affect auditors' judgments under principles- and rules-based accounting standards.

As in all studies, there are limitations that provide opportunities for future research that could add significantly to extending the implications of this study. First, similar to other studies that examine issues related to principles vs. rules-based accounting standards, our study uses an experimental case involving leases where rules-based standards prescribe "bright-lines" that define operating and capital leases. However, prior research suggests (e.g., Mergenthaler 2009) that accounting standards under a rules-based regime (e.g., US GAAP) can vary widely regarding the extent to which specific standards are defined by "bright-lines". For example, Mergenthaler (2009) states that U.S. GAAP relating to leases has a higher level of rules-based characteristics such as bright-line thresholds, scope and legacy exceptions, high level of implementation guidance and detail, than do accounting standards related to other issues such as inventory pricing. Hence, an issue for future research is to examine if the findings of this study extend to rules-based accounting standards that have lower levels of rules-based characteristics. Second, participants in our study were U.S. auditors; hence it is difficult to determine the extent to which their prior experience in the U.S. context influenced their judgments. However, we find that prior experience with IFRS engagements as well as with public companies domiciled outside

the US were not significant covariates in any of the analyses. Nonetheless, future studies should examine if the auditors who primarily practice in regulatory and market environments other than the U.S. exercise similar judgments. Finally, we examined individual judgments where auditors did not have the option to refer any questions to the national office. Prior research (Salterio & Denham, 1997) suggests that in matters of financial reporting disputes the national practice office may have substantial influence over the resolution of these types of issues which may become more prevalent in a principles-based regime.

The results of this study add to the existing literature on the potential for the adoption of a principles-based regime to enhance the quality of the financial reporting process. Of note, the findings shed light on the differential role and impact of the regulatory environment in a rules-based and in a principles-based regime, a significant issue for practice and future research.

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## **EXHIBIT 1. Manipulations**

### **PANEL A. Type of Accounting Standard**

#### **Principles-based:**

The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

A lease is classified as a capital lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

#### **Rules-based:**

If a lease meets any of the criteria specified below, it is to be recorded as a capital lease; otherwise it is to be accounted for as an operating lease:

- 1) The term of the lease is equal to or greater than 80% of the leased asset's useful life
- 2) The present value of the lease payments is equal to or greater than 80% of the fair market value of the leased asset or
- 3) At the end of the lease term, asset ownership is transferred to the lessee.

### **PANEL B. Regulatory Enforcement Regime**

#### **Strong Regulatory Enforcement:**

The Investor Oversight Board (IOB) is the principal regulatory agency that oversees the efficient and orderly functioning of all capital markets in country X. The IOB's power over the accounting profession is unrestricted. The Board has the power to order the public accountant to perform or desist from performing specific actions to rectify the violation of securities laws resulting from the issuance of misstated financial statements or for violations of auditing standards. The IOB also has the power to hold the public accountant liable for significant sanctions or penalties when the financial statements of the company are materially misstated. The Board has used these powers in the past, and sanctions against the accounting profession have included admonitions, temporary and permanent loss of license to practice, damages, penalties, and criminal prosecution. The IOB can issue directives for public accountants that are required to be followed. Finally, the IOB has the ultimate investigative powers to command documents and subpoena the testimony of witnesses when investigating violations of securities laws.

The Chairperson and the members of the Board are appointed and dismissed by the Executive branch of the government, but only with the express consent of the Legislative branch. Board members are appointed for five-year terms, and have high autonomy in their decisions.

**Weak Regulatory Enforcement:**

The Investor Oversight Board (IOB) is a regulatory agency that oversees the efficient and orderly functioning of all capital markets in country X. Its power over the accounting profession is, however, relatively restricted. For instance, the Board does not have the power to order the public accountant to perform or desist from performing specific actions to rectify the violation of securities laws resulting from the issuance of misstated financial statements or for violations of auditing standards. Further, the IOB does not have the power to hold the public accountant liable for significant sanctions or penalties when the financial statements of the company are materially misstated. Finally, the IOB cannot command documents and subpoena the testimony of witnesses when investigating violation of securities laws without obtaining the prior approval of other government agencies. Since this prior approval is not always granted, the IOB's investigative powers are limited.

The Chairperson and the members of the Board are appointed and dismissed unilaterally by the Executive branch of the government; the consent of the Legislative branch is not required. Board members are appointed for two-year terms, and have limited autonomy in their decisions.

**TABLE 1. Descriptive Statistics for the Expected Final Lease Classification<sup>a</sup>**

<b>Accounting Standard<sup>b</sup></b>	<b>Regulatory Enforcement Regime<sup>c</sup></b>	<b>Mean</b>	<b>Std. Deviation</b>	<b>N</b>
Principles	Strong Enforcement	4.48	1.23	25
	Weak Enforcement	3.71	1.40	24
	Total	4.10	1.36	49
Rules	Strong Enforcement	5.22	1.57	23
	Weak Enforcement	5.58	1.61	24
	Total	5.40	1.58	47
Total	Strong Enforcement	4.83	1.43	48
	Weak Enforcement	4.65	1.77	48
	Total	4.74	1.60	96

<sup>a</sup> Expected final lease classification was measured by participants' responses to the question: How likely is it that the final accounting treatment of the transaction will be to classify it as an operating lease (1 = not likely, 7 = very likely). Higher means therefore indicate more aggressive financial reporting.

<sup>b</sup> Accounting standard was manipulated at two levels: principles-based and rules-based.

<sup>c</sup> Regulatory enforcement regime was manipulated at two levels: strong and weak.

**TABLE 2. How Accounting Standard<sup>a</sup> and Regulatory Enforcement Regime<sup>b</sup> Affect the Expected Final Lease Classification<sup>c</sup>**

**PANEL A. ANOVA**

	df	MS	F	Sig.
Accounting Standard	1	40.91	19.31	0.00
Regulatory Enforcement Regime	1	0.99	0.47	0.50
Accounting Standard x Regulatory Enforcement Regime	1	7.76	3.66	0.06
Error	92	2.12		

**PANEL B. Planned Contrasts**

		<u>t</u>	<u>Sig.<sup>d</sup></u>
<b>H1</b>	Under strong regulatory enforcement, auditors' propensity to constrain aggressive reporting will be greater in a principles-based accounting regime than in a rules-based accounting regime:  $\mu_{principles, strong\ enforcement} < \mu_{rules, strong\ enforcement}$	-1.82	0.04
<b>H2</b>	Auditors' propensity to constrain aggressive reporting will be greater in a principles-based regime, regardless of the strength of regulatory enforcement, than in a rules-based accounting regime with strong regulatory enforcement:  $\mu_{principles} < \mu_{rules, strong\ enforcement}$	-2.94	0.00

<sup>a</sup> Accounting standard was manipulated at two levels: principles-based and rules-based.

<sup>b</sup> Regulatory enforcement regime was manipulated at two levels: strong and weak.

<sup>c</sup> Expected final lease classification was measured by participants' responses to the question: How likely is it that the final accounting treatment of the transaction will be to classify it as an operating lease (1 = not likely, 7 = very likely). Higher means therefore indicate more aggressive financial reporting quality.

<sup>d</sup> One-tailed p-values are reported in cases where we have directional expectations.