

Discussion of  
Standard precision and aggressive financial reporting:  
The influence of incentive horizon

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# Construct Validity

- The manuscript flips between variation in “standards precision” and the notion of “principles versus rules” as if they are interchangeable and dispositive characteristics of U.S. GAAP and IFRS.
- As noted by Schipper (2003), financial reporting standards can be regarded as principles-based if they are consistent with the conceptual framework.
- An excellent example is SFAS 141R, which requires recognition of assets and liabilities that meet the elements definitions in the conceptual framework. In addition, noncontrolling interest is required to be measured at fair value because it provides the most relevant information to financial statement users (SFAS 141R, para. B207).
- Although, a mostly converged standard, IFRS 3 allows a transaction-by-transaction choice of whether to measure NCI at fair value or at the proportionate amount of the subsidiary’s pre-transaction book value. This clearly reduces comparability.
- This choice is allowed because the IASB could not get sufficient support for either measurement method and this would have risked approval of the overall standard (IFRS 3, para. BC210).
- So, in this example, I would consider IFRS to be less “principled” despite the fact there is no real difference in the precision of the two standards’ language.

# Setting

- Published standards precision / principles-versus-rules experiments in last 10 years:
  - Agoglia, Douppnik & Tsakumis (2011) – Leasing
  - Backof, Bamber & Carpenter (2016) – Leasing
  - Cohen, Krishnamoorthy, Petcheva & Wright (2013) – Leasing
  - Gimbar, Hansen & Ozlanski (2016) – Leasing
  - Grenier, Pomeroy & Stern (2015) – Leasing
  - Jamal & Tan (2010) – Leasing
  - **McCarthy & McCarthy (2014) – Revenues**
  - **Messier, Quick & Vandervelde (2014) – R&D**
  - Peytcheva, Wright & Majoor (2014) – Leasing
- Libby, Rennekamp & Seybert (2015, pp. 28-29) note that “few studies have identified the key attributes of principles versus rules that facilitate or constrain aggressive reporting, focusing instead on specific accounting issues such as leases... Future research might attempt to develop a broader conceptual framework that aids in operationalizing these key attributes as opposed to selecting a specific accounting standard in an attempt to more directly address a current reporting controversy.”

# Theory & Tests

- The theory section of the manuscript proposes a specific mechanism through which investment horizon and standard precision interactively affects lease capitalization judgments. Self-Interested Reporting Incentives -> Regulator Second Guessing -> Financial Reporting Choices
- This is based on Agoglia et al.'s (2011) theory, but omits one link in their paper (i.e., economic substance). Why? This is also confusing because the manuscript includes economic substance as an ad hoc factor in the mediation analysis.
- Given the stark difference in short-horizon perceptions of regulator second guessing and economic substance in Agoglia et al (2011) and the present manuscript, readers would benefit from discussion of comparisons between the two studies.
- For example, the average score for regulator second guessing (across conditions) is 6.64 in the less precise condition and 2.14 in the more precise condition in Agoglia (2011). In contrast, in the present study, the short horizon averages are 5.43 in the less precise condition and 5.69 in the more precise condition.
- As has been illustrated by the “Reproducibility Project” in psychology, we need to be concerned with inferences promoted by single, well-cited research studies.

## Design & Inferences

- As noted in footnote 9, the instrument required each subject to projectively evaluate her/his “future self,” and to relate it to her/his “current self.” In theory, this type of manipulation should not explain differences between conditions; however, it can enhance subjects’ sensitivity to time-horizon-related stimuli. How dependent are the findings to this unusual pre-task?
- As noted in footnote 12, the manuscript also required subjects to make a decision about cuts to current R&D spending, with current cuts translating to higher likelihood of future competitive disadvantage. There are no differences related to incentive horizon. This is puzzling given the prominent role of incentive horizon in the manuscript’s motivation and theory.
- The results of the mediation analysis are mostly a bust. However, even if the results were as strong as Agoglia et al.’s (2011), we need to temper inferences and claims in measured mediation settings. See Asay, Guggenmos, Kadous, Koonce and Libby (2019).

# Did the Experiment Capture the Most Important Judgments?

- The present study (and most prior lease-related experiments-based work) has two key features in operationalizing the standard precision manipulation:
  - Use the old language from US GAAP and IFRS: “The lease term is [equal to 75% or more vs. for the major part] of the estimated economic life of the leased property.”
  - Fix and treat as exogenous all other attributes of the lease, company and economic context. Also, tell subjects the renewal option “**has a monthly rental payment to be set at 92% of the fair rental value for the equipment**,” and “**economic life of 10 years.**”
  - The context appears to include selective precision in other inputs to the judgment.
- Most commercial arrangements, like leases, have numerous inputs that can potentially influence accounting treatments for the arrangements
- Assume I’m a manager with incentives to purposefully intervene in the financial reporting process, with the intent of obtaining some private gain. In the leasing setting, and specifically limiting my analysis to the 75% test, where will I most likely attempt to find slack and purposefully intervene?
  - Estimated economic life? Estimated expected economic rental rates during option periods? Precision of language in the accounting standard?
- More importantly, does flexibility in these other features cause effects of standards precision to be mitigated or exacerbated?

# Incentive Horizon Manipulation

- The aspects of the CEO's hypothetical compensation package on which subjects (who assume the role of a controller) focused is unclear.
- CEO's bonus threshold requires \$2 million of expense reduction. Analysts' forecast target requires \$1 million of expense reduction. Prior to lease classification, all subjects reduced R&D by \$1 million. Given this choice, what is the second-order preference revealed by subjects' interpretation of the more- and less-precise leasing standard?
- This tiered-type incentive system is often described as a "quota system" (Prendergrast 1999), and prior research documents gaming of these systems. Examples:
  - Courty & Marschke (2004): job training volume shifting with annual (June 1) agency reporting dates for job-training participation
  - Healy (1985): with executives managing earnings around floors and ceilings in bonus plans
  - Leventis (1997): because of annual NYC mortality reporting systems, surgeons take less risky cases when approaching threshold.
- The accounting cycle and incentive systems introduce multi-period strategies. How do the multi-period nature of these systems interact to influence interpretation of bright-line versus vague standards' structures?
- Also, how can we evaluate "goodness" of subjects' responses without a control condition that lacks explicit mention of incentives? Wouldn't this allow us to better understand the right answer? Although, experiments are good at demonstrating differences and are horrible at parameter estimation, what's the correct answer? Capital lease? Operating lease

# Manuscript's Rhetoric

- The manuscript mischaracterizes the convergence activities of the FASB and IASB. Norwalk Agreement (2002) and Memorandum of Understanding (2006) are examples that predate SEC's 20-F reconciliation elimination and convergence proposal.
- Page 15 of the manuscript states ASC 810 (i.e., consolidations) is more rules based because it includes a 50 percent ownership threshold as compared to IFRS 10 which is based on the effective power of parent company. Actually, ASC 810 requires companies to go through the variable interest entity (VIE) evaluation before being considered a voting interest entity. And, the VIE evaluation includes all sorts of squishy language related to "power to direct activities," just like IFRS 10.
- The manuscript does not provide standard information about the number of analysts contacted, the means of contact, response rates, etc. In addition, the sample size reported in the manuscript is different from that reported in Essay 1 in Hunter's (2017) dissertation.
- The instrument included many manipulation check questions; however, the manuscript does not report them. From a theory-testing perspective, inferential statistics should be reported for the sample excluding subjects who failed the manipulation check questions.