STANDARD PRECISION AND AGGRESSIVE FINANCIAL REPORTING: THE INFLUENCE OF INCENTIVE HORIZON

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AGENDA

I. Motivation
II. Background
III. Hypothesis Development
IV. Research Design
V. Results
VI. Conclusions

MOTIVATION

Motivation

- Extant research on standard precision suggests that financial statement preparers are likely to report less aggressively under principles-based standards (Psaros and Trotman 2004; Agoglia et al. 2011)
- If research is to be informative for regulators as they consider further standard migration, need to explore how standard precision is impacted by other factors which motivate aggressive financial reporting
- Given the prevalent use of restricted forms of stock-based compensation in firms, and the empirical research which shows a reduction in aggressive financial reporting with longer incentive horizon

Research Question

How does incentive horizon influence the relationship between accounting standard precision and financial statement preparers' decision to report aggressively?

STANDARD PRECISION

More precise standards

- Provide a common knowledge base and set of assumptions (Schipper 2003)
- Shield preparers from criticism of aggressive reporting (Benston et al. 2006)
- Encourage opportunistic transaction structuring (Imhoff and Thomass 1988)
- Dissimilar transactions forced into same accounting treatment (McCarthy and McCarthy 2014)

Less precise standards

- Judgment allows transactions to reflect true economic substance (Shortridge and Myring 2004)
- Due to greater degree of interpretation involved, preparers may not apply standards consistently (McCarthy and McCarthy 2014)

STANDARD PRECISION AND AGGRESSIVE FINANCIAL REPORTING

- More precise standards are associated with incentive-consistent aggressive financial reporting (Psaros and Trotman 2004)
- Less precise standards are associated with less aggressive financial reporting (Agoglia et al. 2011)
  - Concern for regulator second-guessing of decision
  - Concern for the economic substance of the transaction

INCENTIVE HORIZON

Stock-based Compensation

- Stock-based compensation aims to address agency problem (Jensen and Meckling 1976; Morck et al. 1988)
- May provide an incentive to manage earnings (Cheng and Warfield 2005; Erickson et al. 2006; Chava and Purnanandam 2010)

Incentive Structure

- How incentives are structured influences decision horizon (Bebchuk and Fried 2010)
- Fraud firms have greater incentives from unrestricted holdings (Johnson et al. 2009)
- Shorter CEO pay duration is associated with a greater incentive to manipulate financial performance (Gopalan et al. 2014)

HYPOTHESIS DEVELOPMENT

- Executives will focus on maximizing long-term firm value rather than short-term profitability when incentive structure rewards long-term performance
- Concerns about justifying decisions to auditors or regulators will decrease when incentives favor long-term since external watchdogs are more concerned with earnings management which favors short-term profitability (Gigler et al. 2014; AICPA 2002; Francis and Krishnan 1999)
- Decreased concerns about oversight and the economic substance of transactions will provide more freedom to take advantage of the flexibility of less precise standards

Hypothesis: When the incentive horizon changes from short-term to long-term, earnings management behavior will increase more for less precise standards, relative to more precise standards.

RESEARCH DESIGN

- Demographic Data

- Background Information
- Incentive Horizon Manipulation (*INCENTIVE_HORIZON*)
  - Stock can be sold at any time (short-term incentive horizon)
  - Stock cannot be sold for five years after receipt (long-term incentive horizon)

- Lease Accounting Information
- Standard Precision Manipulation (*STANDARD_PRECISION)*
  - Capital lease if lease term is greater than 75% of economic useful life (more precise)
  - Capital lease if lease term is for the major part of economic useful life (less precise)
- Financial Statement Impact of Lease Classification Decision

- Lease Classification Decision (*LEASE_CLASSIFICATION)*

- Manipulation Check
- Debriefing

DESCRIPTIVE STATISTICS

	INCENTIVE_HORIZON: Short-Term	*INCENTIVE_HORIZON: Long-Term*	Row Means
STANDARD_PRECISION: Less Precise	6.93 (2.95) [35]	5.09 (3.66) [32]	6.05 (3.41) [67]
STANDARD_PRECISION: More Precise	5.60 (3.42) [35]	6.39 (3.49) [33]	5.99 (3.46) [68]
Column Means	6.26 (3.24) [70]	5.75 (3.61) [65]	6.02 (3.42) [135]

RESULTS

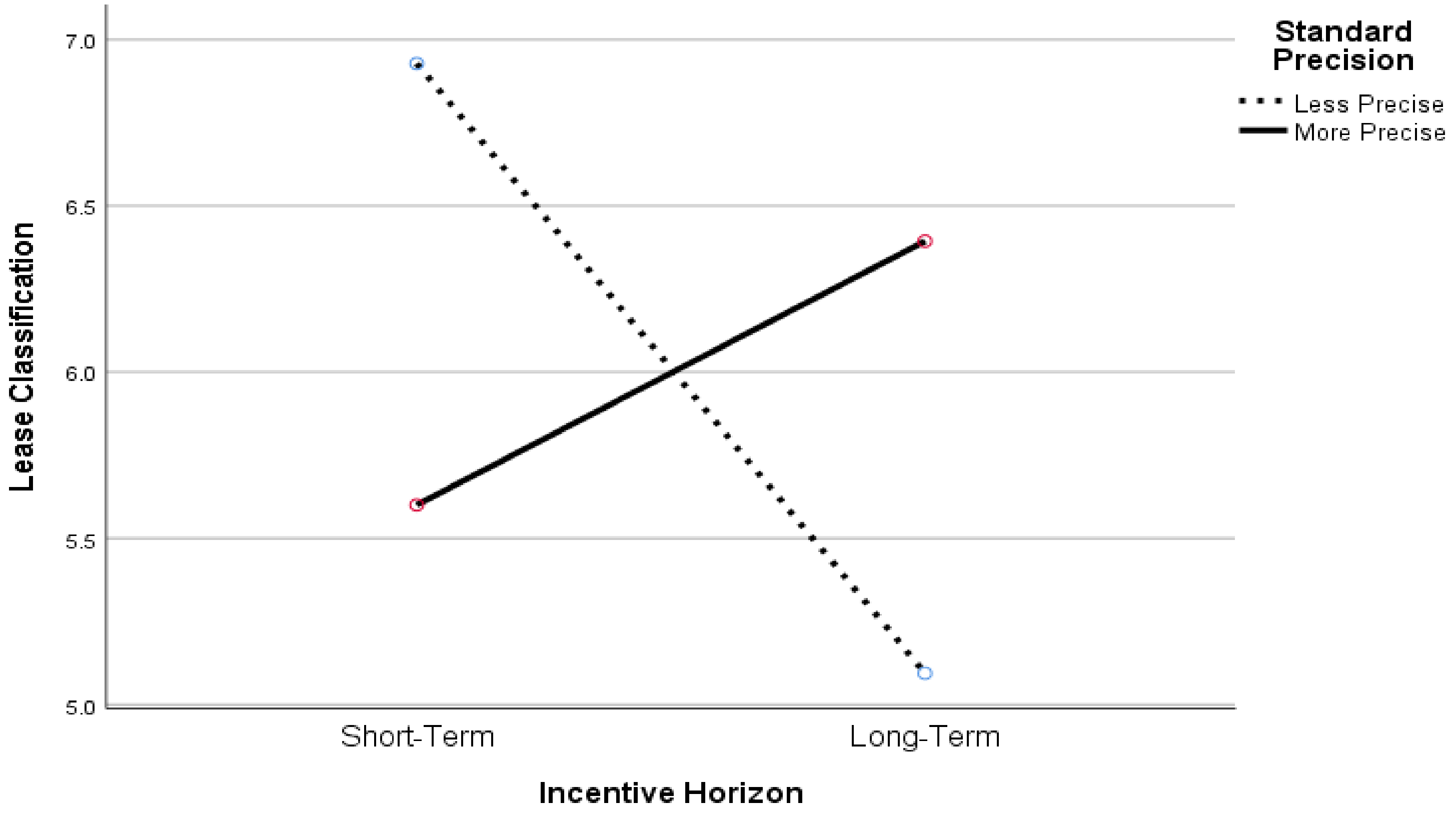
Factor	df	Mean Square	F-Value	*p*-value
INCENTIVE HORIZON (IH)	1	9.13	0.80	0.374
STANDARD PRECISION (SP)	1	0.01	0.01	0.981
IH X SP	1	58.22	5.08	**0.026**
Error	134			

RESULTS

Simple Effects Test	t-statistic	*p*-value
When the incentive horizon is long-term, financial statement preparers will be less likely to engage in income-increasing earnings management behavior than when the incentive horizon is short-term.	2.22	0.014

Planned Contrast	*t*-statistic	*p*-value
When the incentive horizon changes from short-term to long-term, earnings management behavior will increase more for less precise standards, relative to more precise standards.	2.25	0.013

RESULTS



Standard Precision
Less Precise
More Precise
7.0
6.5
6.0
5.5
5.0
Lease Classification
Short-Term
Long-Term
Incentive Horizon

MEDIATION ANALYSES

	Incentive Horizon: Short-Term			Incentive Horizon: Long-Term		
Debriefing Item	**Less Precise**	**More Precise**	**Total**	**Less Precise**	**More Precise**	**Total**
Regulator Second-Guessing	5.43 (3.25)	5.69 (3.25)	5.57 (3.23)	5.06 (2.75)	5.08 (3.08)	5.07 (2.91)
Economic Substance	7.65 (2.18)	7.67 (2.37)	7.66 (2.26)	6.58 (2.82)	7.39 (2.41)	7.00 (2.62)

Effect: -0.987 LLCI = -1.955 UCLI = -0.210

ADDITIONAL TESTS

- Including interpretation of “for the major part of” as covariate → results unchanged
- Restrict sample to participants who interpret “for the major part of” within relevant range → results are similar to initial results
- Examine whether there is a country effect using country indicator variable → indicator variable is not significant and hypothesis tests are unchanged
- Examine whether there is an effect of job title → indicator variable is not significant and hypothesis tests are unchanged

SUMMARY OF RESULTS

- Incentive horizon of executives changes the nature of earnings management decisions by preparers.
- When incentive horizon moves from short-term to long-term, income-increasing earnings management behavior increases when standards are less precise
- Concerns over the economic substance of the transaction mediate relationship between standard precision and earnings management decisions when incentive horizon is short-term
- Concern for economic substance no longer influence decision when incentive horizon is long-term

IMPLICATIONS OF RESEARCH

Implications of Research

- Incentive structure and precision of accounting standards jointly impact income-increasing financial reporting decisions
- Market implications of standard precision cannot be fully understood when examined in isolation

Limitations and Directions of Future Research

- Experiment uses superseded leasing standards, so the construct of standard precision could be explored using current standards
- Explore other factors associated with aggressive financial reporting for potential influence on standard precision