More Precise versus Less Precise Accounting Standards:
The Effect of Auditor Judgment Frameworks in Constraining Aggressive Reporting

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ABSTRACT

We experimentally investigate auditors’ judgments under accounting standards that differ in their precision and whether alternative judgment frameworks help auditors constrain aggressive financial reporting. We find that auditors are more likely to allow aggressive reporting when accounting standards are less precise, but employing a judgment framework reduces auditors’ acceptance of such aggressive reporting. In particular, a framework based on the SEC’s Advisory Committee on Improvements to Financial Reporting’s (CIFiR’s) recommendation for the critical evaluation of the pros and cons of alternative accounting methods helps auditors constrain aggressive reporting under less precise standards. However, we find evidence that modifications to CIFiR’s proposed judgment guidance based on Construal Level Theory improve the quality of auditors’ judgments and lead to less aggressive reporting. These results inform regulators, standard-setters, and auditors on how accounting precision affects auditors’ response to aggressive reporting and on the effectiveness of different judgment frameworks in constraining aggressive reporting.

Keywords: auditing, accounting standard precision, judgment frameworks
I. INTRODUCTION

As the convergence between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) continues to move forward (FASB 2010; FASB 2013), there are concerns about the move to a less precise set of global accounting standards. One concern is whether auditors can constrain managers’ aggressive financial reporting under less precise accounting standards (SEC 2008). Another concern is whether investors and the courts will respect auditors’ judgments when they are not supported by precise guidance (PCAOB 2008). In response to this concern, the SEC’s Advisory Committee on Improvements to Financial Reporting (CIFiR) proposed guidance to be used when making and evaluating professional judgments (CIFiR 2008; FEI 2008). Audit firms have recently developed judgment frameworks based on CIFiR’s recommendations (e.g., Deloitte 2009; KPMG 2011), but the impact of such frameworks on auditors’ judgments under accounting standards that differ in their precision is unknown. In this study, we examine the joint effects of accounting standard precision and alternative judgment frameworks on auditors’ constraint of management’s aggressive financial reporting.

Given the increasing judgment and complexity in financial reporting, it is essential that auditors exercise sound professional judgment regardless of the level of standard precision (PCAOB 2012). However, the Financial Accounting Standards Board (FASB) worries that auditors rely too heavily on rules and are reluctant to use sound professional judgment when faced with less precise guidance (FASB 2004). Further, the Public Company Accounting Oversight Board (PCAOB) is concerned that auditors are too compliance-oriented and not sufficiently fraud-oriented to effectively deter management’s aggressive reporting under more
precise standards (Carmichael 2003; PCAOB 2004, 2007; Hammersley et al. 2010). Accounting literature supports these concerns. For example, Hackenbrack and Nelson (1996) and Kadous et al. (2003) find that auditors exploit the ambiguity in accounting standards to justify the client-preferred aggressive accounting method. However, more precise standards are not necessarily the solution as auditors tend to allow earnings management through transaction structuring when the governing rules are precise and transaction structuring is consistent with the rules (Nelson et al. 2002; Nelson 2003). Thus, it is important to identify effective ways to improve the quality of auditors’ judgments under both more and less precise accounting standards.

In response to standard setters’ and regulators’ growing concerns about auditor judgment (FASB 2004; PCAOB 2004, 2007, 2012), CIFiR proposed judgment guidance aimed at improving the quality of auditors’ judgments and allowing for consistent evaluation of such judgments (CIFiR 2008). The goal of the proposed guidance is to encourage auditors to follow a disciplined process in making judgments. This process would entail a “critical and reasoned evaluation made in good faith,” including the evaluation of the pros and cons of all reasonable alternative accounting methods (CIFiR 2008, p. 94-95). CIFiR hopes that consideration of the pros and cons of accounting alternatives will improve the quality of auditors’ judgments and increase auditors’ propensity to curb aggressive reporting even when faced with less precise accounting standards.

1 Consistent with Hammersley et al. (2010), auditors that are compliance-oriented are relatively more focused on completing the audit program steps whereas auditors that are fraud-oriented are more focused on detecting fraud.
2 In recommendation 3.5 of CIFiR’s final report, CIFiR recommends that the PCAOB develop guidance as to how it evaluates the reasonableness of auditors’ judgments (CIFiR 2008). However, CIFiR notes that the PCAOB should rely on the SEC’s judgment guidance when evaluating accounting judgments. As yet, the SEC has not issued such guidance.
3 CIFiR identifies 11 key components to a reasonable accounting judgment. One of the key components that the CIFiR suggests the SEC should consider when evaluating the reasonableness of an accounting judgment is the analysis of alternative views or estimates, including pros and cons for reasonable alternatives (CIFiR 2008). We study this one component because the judgment frameworks developed and implemented by the Big 4 accounting firms specifically include this component of the CIFiR’s proposed guidance. For example, Deloitte (2009) describes issue analysis as including the analysis of the pros and cons of the reasonable alternatives.
Recent theory in psychology (Construal Level Theory: Liberman and Trope 1998; Trope and Liberman 2003; Trope et al. 2007) suggests that auditors may further benefit from a modification to this guidance that psychologically distances auditors from the client’s preference. Construal Level Theory proposes that psychological distance from an event fosters big picture thinking and the impartial processing of all available alternatives (Freitas et al. 2004). In the auditing setting, the event in question is the client’s preference to aggressively account for a specific transaction. Freitas et al. (2004) suggest that asking auditors to think broadly about why the transaction should be accounted for in a certain way will psychologically distance them from the client’s aggressive reporting preference, allowing auditors to focus more on the economic substance (and less on the structured form) of the transaction. We investigate whether this modification to the CIFiR’s proposed guidance helps auditors constrain aggressive reporting.

We conduct an experiment to investigate these issues. Two hundred and nineteen audit managers and partners from a Big 4 accounting firm participated in a lease classification decision. We manipulate two independent variables: accounting standard precision and judgment framework. The first independent variable, accounting standard precision, is manipulated between participants. The more precise standard is based on FASB Accounting Standards Codification 840-10-25-1 and the less precise standard is based on International Accounting Standard (IAS) 17. The second independent variable, judgment framework, is also varied between participants. Participants in the no framework condition are only required to consider the applicable authoritative guidance under either the more or less precise standard and serve as a control group. The second condition, the critical evaluation framework, requires

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4 We chose the lease classification scenario because it is a good example of a U.S. GAAP bright-line standard that allows managers to opportunistically structure a transaction to ensure a preferred way of accounting (Maines et al. 2003; Jamal and Tan 2010). Other research (e.g., Jamal and Tan, 2010; Agoglia et al. 2011; Cohen et al. 2013) examining aspects of principles-based versus rules-based accounting standards also employ the lease classification scenario.
auditors to consider the pros and cons of the non-client-preferred accounting method. CIFiR highlights this type of critical reasoning as a key component to reasonable auditing judgments (CIFiR 2008). Our third condition (the hybrid framework) is a balanced framework that combines the CIFiR’s proposed guidance for auditors to consider all of the alternatives with the technique employed in Construal Level Theory research to create psychological distance. In particular, auditors are asked to think broadly about why the transaction should be accounted for under both of the alternatives. Finally, following prior research on how to create psychological distance, auditors in the why framework condition are only asked to consider one of the alternatives, the non-client preferred method.

Consistent with our expectations, we find that auditors are more likely to allow the client to report aggressively when the accounting standards are less precise, but the use of a judgment framework reduces auditors’ acceptance of such aggressive reporting. The critical evaluation framework based on CIFiR’s recommendations helps auditors constrain aggressive reporting under less precise standards, but not more precise standards. However, both the hybrid and why frameworks based on Construal Level Theory incrementally help auditors curb aggressive reporting under less precise standards, with the why framework being the only framework to enhance auditors’ skepticism under more precise standards. Thus, our findings suggest that a modification to CIFiR’s proposed judgment guidance based on Construal Level Theory will improve the quality of auditors’ judgments and lead to less aggressive reporting.

Our study is important for several reasons. First, we answer the Center for Audit Quality (CAQ)’s call for research that examines auditors’ professional judgments in the application of principles-based versus rules-based approaches to accounting (CAQ 2012). Consistent with the concerns expressed by the SEC regarding auditors’ constraint of opportunistic reporting under
IFRS without the bright lines present in U.S. GAAP (SEC 2008), we show that auditors are less likely to curb aggressive reporting when operating under less precise accounting standards. This finding is especially important given FASB’s current trend of issuing less precise accounting standards and the continued convergence with IFRS (FASB 2010; FASB 2013).

Second, our findings support the potential of CIFiR’s recommendations to improve audit quality and, in particular, to bolster auditors’ ability to curb management’s aggressive reporting. At the center of the proposed professional judgment guidance is auditors’ evaluation and documentation of alternatives to management’s preferences. This study provides evidence that judgment frameworks based on CIFiR’s proposed judgment guidance can improve auditors’ judgments under less precise accounting standards. However, we find that auditors incrementally benefit from a modification to that proposed guidance that psychologically distances auditors from the client’s preference and fosters big picture thinking. By shedding light on the effectiveness of CIFiR’s proposed auditor judgment guidance, this study should be helpful to standard setters contemplating issuing formal judgment guidance and audit firms interested in refining their existing judgment frameworks.

Third, auditors’ failure to consistently exercise sufficient professional skepticism is concerning to many (PCAOB 2010, 2012), prompting calls for research in this area (Nelson 2009; CAQ 2012; Franzel 2013; Hurtt et al. 2013). Nelson (2009) specifically urges scholars to think about how to restructure the task to enhance auditors’ professional skepticism. Construal Level Theory suggests that auditors may not always exhibit the appropriate professional skepticism when evaluating the accounting method for a given transaction because they focus too heavily on the low-level details of the transaction that support the client-preferred accounting method. As such, we expect and find that restructuring auditors’ thought processes to focus on
the high-level economics of the transaction enhances auditors’ skepticism and leads to less aggressive reporting. Thus, auditors charged with a task that requires big picture thinking may benefit from a modification to the CIFiR’s guidance based on Construal Level Theory.

The remainder of the paper is organized as follows. Section II provides background information, summarizes the theory underlying our analysis, and develops our hypotheses. Section III describes the sample and experimental design, Section IV presents the results of our study, and Section V concludes.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Auditors’ Judgments and Accounting Standard Precision

The move towards less precise accounting standards in the U.S. has spurred much debate. The SEC summarizes the issue as follows:

Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgment by preparers and auditors. Rules-based standards often provide a vehicle for circumventing the intention of the standard (SEC 2003).

The SEC concludes that less precise, principles-based standards provide the best opportunity for the accounting to capture the underlying economic reality. Nevertheless, opponents of the switch to less precise accounting standards warn that the latitude inherent in these standards is a double-edged sword. While this latitude allows managers to choose accounting methods that reflect their informed understanding of the underlying economics of the transactions, managers may also exploit the ambiguity inherent in these standards to justify their aggressive accounting.

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5 The SEC has described U.S. GAAP as rules-based when drawing comparisons to IFRS, a principles-based set of standards (SEC 2008, 2010). Others (e.g., Schipper 2003; Hail et al. 2010) argue that U.S. GAAP is principles-based but over time has accumulated more guidance. However, Hail et al. (2010, p. 376) point out that there is little disagreement that IFRS are less precise and provide less guidance than U.S. GAAP and that, as a result, “a key difference between the two sets of standards is the amount of discretion that firms and managers have.”
for certain transactions (Maines et al. 2003; Hail et al. 2010). Hail et al. (2010) conclude that this increased role of management’s discretion under less precise accounting standards is likely to make SEC enforcement, firms’ internal controls and, we would add, the external audit more important for reporting quality.

Two recent studies (i.e., Jamal and Tan 2010; Agoglia et al. 2011) examine the implications of moving to a less precise accounting system on firm managers’ propensity to aggressively report. Agoglia et al. (2011) find that CFO’s concerns about second-guessing and the costs associated with regulation and litigation increases their focus on the underlying economics of the transaction. This, in turn, results in less aggressive reporting under less precise standards. Given that the actual amounts and disclosures reported in the financial statements are subject to an audit prior to the release of the financial statements to the public, Jamal and Tan (2010) manipulate the type of auditor mindset and investigate its’ influence on managers’ reporting decision. They find that less precise accounting standards are associated with less aggressive reporting, but only when the auditor also has a principles-oriented mindset. Thus, the external auditor plays an important role in constraining managements’ aggressive reporting under less precise accounting standards. We complement these studies by investigating auditors’ judgments under more and less precise accounting standards.

We first investigate auditors’ propensity to allow aggressive reporting under different levels of standard precision. One argument for the switch to less precise accounting standards is that clear and enforceable rules provide opportunities for management to structure transactions to ensure their preferred accounting method (Maines et al. 2003; Schipper 2003; SEC 2008). Prior research finds that auditors tend to allow such earnings management through transaction structuring when the governing rules are precise and transaction structuring is consistent with the
rules (Nelson et al. 2002; Nelson 2003). More specifically, auditors are reluctant to make the “substance over form” argument against the client-preferred method when the transaction meets the bright lines, even though the bright lines do not apply in all circumstances (Nelson et al. 2002). Therefore, proponents of the switch to less precise standards argue that less precise standards will help curb aggressive reporting by forcing auditors to evaluate the transaction according to the relevant accounting principles rather than the prescribed rules. However, the prior research examining auditors’ allowance of aggressive reporting under less precise standards is mixed.

Two concurrent studies support the argument that less precise standards will lead to more conservative reporting. Cohen et al. (2013) investigate a scenario where the transaction is structured to strictly comply with a rule that does not reflect the economic substance of the transaction. They find that auditors constrain aggressive reporting to a greater extent under less precise standards compared to more precise standards. Yet, it is unclear if this finding will hold when the transaction is not structured to clearly comply with a rule found in more precise guidance. Another study examines the effect of standard precision on auditors’ motivation and evidence demands and finds that less precise standards increase auditors’ process accountability (Peytcheva et al. 2013). This heightened accountability leads to greater epistemic motivation and demand for both diagnostic and non-diagnostic evidence. However, prior experimental (e.g., Glover 1997; Hoffman and Patton 1997) and archival (Waller and Zimbelman 2003) research finds that the quality of auditors’ judgments suffer due to the dilution effect, whereby the presence of non-diagnostic evidence weakens the impact of diagnostic information on auditors’

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6 For example, companies exploit the precision in Accounting Standards Codification 840-10-25-1 Accounting for Leases by intentionally structuring lease contracts to avoid capitalization of their leases in favor of operating leases that present a more favorable picture of their overall financial condition (Imhoff and Thomas 1988; Pulliam 1988).
judgments (Nisbett et al. 1981). Consequently, it is not clear if less precise standards will always be associated with more conservative reporting.

Contrary to the argument above supporting the switch to less precise accounting standards, a long stream of auditing research generally finds that auditors respond to incentives to permit aggressive reporting by interpreting imprecise standards or precedents as allowing such reporting. Studies examining the role of ambiguity and auditors’ incentives (Hackenbrack and Nelson 1996; Salterio and Koonce 1997; Nelson et al. 2002; Kadous et al. 2003; Blay 2005) and the existence of authoritative guidance (Trompeter 1994; Cuccia et al. 1995; Ng and Tan 2003) on auditors’ judgments and decision making under U.S. GAAP suggest that less precise standards will lead to more aggressive reporting. While these findings may not hold in today’s post-Sarbanes Oxley Act environment where auditors’ judgments are subject to intense scrutiny from internal quality reviews and external reviews by regulators, auditors’ incentives to please the client are strong, persistent, and not easily overcome.

We chose to investigate auditors’ propensity to allow aggressive reporting under different levels of standard precision in a setting where auditors are required to use their judgment regardless of the level of standard precision. In particular, auditors must determine whether or not a lease contract contains a bargain renewal option that would increase the lease term significantly, making it easier to justify the operating lease classification under both the more and the less precise accounting standards. However, in our setting, such aggressive accounting (i.e., classifying the lease as operating as preferred by the client) does not reflect the economic substance of the transaction.7 Thus, we are able to examine the effect of standard precision in a

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7 As part of our pilot testing, we provided the facts of the case to a panel of five practicing audit partners from the three Big Four audit firms that did not participate in the experiment. These partners reviewed the case materials (in the absence of any experimental manipulations). The majority of these partners (four out of five) determined that the lease contained a bargain purchase option and should therefore be capitalized given that the lease will last for 80
setting where the details of the transaction can be interpreted to justify an aggressive accounting method under all levels of standard precision.

In this first hypothesis, we establish the potential role for a judgment framework to improve auditors’ judgments by examining auditors’ judgments under different levels of standard precision. Prior auditing research finds that auditors exploit the subjectivity of the accounting standards and evidence to allow the client-preferred aggressive reporting. For example, auditors tend to acquiesce to the client’s preference when there are conflicting precedents (Saltiero and Koonce 1997) and the accounting standards allow for a range of acceptable alternative accounting treatments (Trompeter 1994). Further, when faced with uncertainty, auditors are willing to sacrifice their reputation for being objective in favor of management’s preferred reporting (Mayhew et al. 2001). In light of the prior research, we argue that auditors are more likely to allow aggressive reporting under less precise accounting standards.

Less precise accounting standards lack precise guidance that can be relied on to challenge management’s aggressive reporting choices. This lack of precise guidance provides more latitude for management’s interpretation of the facts while making it more difficult for auditors to oppose the preferred accounting method (Gibbins et al. 2001). Prior auditing research (e.g., Trompeter 1994; Salterio and Koonce 1997; Nelson et al. 2002) suggests that auditors are more likely to allow management’s aggressive reporting under less precise accounting standards. Further, auditors’ motivation to curb aggressive reporting under less precise standards may
decrease given the recent finding of Kadous and Mercer (2012) that juries are less likely to find auditors negligent for allowing aggressive reporting under imprecise than precise accounting standards. Consequently, we hypothesize the following:

H1: Without a judgment framework, auditors are more likely to allow aggressive reporting under less precise accounting standards compared to more precise accounting standards.

Auditors’ Judgments and Judgment Frameworks

After establishing a baseline for auditors’ propensity to allow aggressive reporting under different levels of standard precision in H1, we examine the theory behind and effectiveness of three alternative judgment frameworks aimed at helping auditors constrain such aggressive reporting. The CIFiR notes that “accounting judgments should be based on a critical and reasoned evaluation made in good faith and in a rigorous, thoughtful, and deliberate manner” (CIFiR 2008, p. 94). When evaluating the accounting method for a given transaction, auditors review the evidence provided by management. Absent a judgment framework, the salience of management’s potentially biased and limited interpretation of the evidence as supporting its preferred accounting method may be detrimental to the quality of auditors’ judgments (Kennedy 1993; Earley et al. 2008). Therefore, we examine the effectiveness of three alternative judgment frameworks that attempt to expand the relevant information auditors consider when making their judgments, especially when applying less precise standards.

CIFiR Recommendation

The audit of financial statements has always required auditors to exercise their professional judgment (CIFiR 2008), but the use and importance of these judgments continues to grow as the overall complexity and estimation uncertainty inherent in financial statements increases (Christensen et al. 2012). In an effort to facilitate auditors’ use of sound professional
judgment, audit firms have developed judgment frameworks that promote a rigorous, thoughtful, and deliberate judgment process (e.g., Deloitte 2009; KPMG 2011). These judgment frameworks are based on CIFiR’s proposed judgment guidance that highlights the important components of reasonable accounting judgments (CIFiR 2008). The components common to all of the frameworks include the identification of the issue, gathering of all of the relevant facts, consideration of the relevant guidance, evaluation of the pros and cons of the reasonable alternatives, and rationale for the final decision (Deloitte 2009; KPMG 2011). However, it is unclear how these judgment frameworks based on the CIFiR’s guidance affect auditors’ propensity to allow aggressive reporting.

CIFiR specifically states that one critical component of a well-reasoned accounting judgment is the evaluation of the pros and cons of all reasonable alternative accounting methods (CIFiR 2008). In other words, auditors should critically consider the arguments for and against accounting for a transaction in a given way. Prior psychology research has investigated individuals’ ability to generate arguments in favor of (pros) and against (cons) a particular position. Koriat et al. (1980) and Hoch (1985) find that individuals tend to spontaneously generate supporting reasons for a given position, but must be explicitly instructed to consider reasons for why that position may not be best. Most related auditing research focuses on auditors’ hypothesis generation and evaluation in the analytical review setting. Evidence suggests that auditors do not spontaneously engage in counterexplanation, but that its use increases auditors’ ability to identify unexpected fluctuations during analytical review (Koonce 1992; Kennedy 1995). Koonce (1992) finds that considering and documenting information not consistent with the target event leads to more reasoned judgments that incorporate information not otherwise considered. Similarly, Heiman (1990) reports that consideration of opposing
scenarios increases auditors’ perceptions of the plausibility and availability of alternative outcomes. In a non-analytical review setting, Earley et al. (2008) find that auditors’ evaluation and documentation of the possible effects of an internal control problem on the financial statements (i.e., hypothetical outcomes) reduces management’s influence on auditors’ internal control judgments. These findings suggest that auditors will benefit from a judgment framework that encourages auditors to critically evaluate the pros and cons of the non-client-preferred accounting method.

**Construal Level Theory**

Although prior research suggests that auditors’ critical evaluation of the accounting alternatives will help curb aggressive reporting, Construal Level Theory (Liberman and Trope 1998; Trope and Liberman 2003; Trope et al. 2007) suggests that auditors may also benefit from a framework that psychologically distances auditors from their client’s preferences. Construal Level Theory explains that individuals can use either concrete, low-level construals or abstract, high-level construals to represent events (Trope et al. 2007). Low-level construals focus on the specific details of the event, while high-level construals are schematic representations that extract the gist of the event from the available information (Trope and Liberman 2003). Construal Level Theory’s basic premise is that individuals use increasingly higher levels of construals to represent an event as the psychological distance from the event increases (Trope and Liberman 2010). This is because psychologically near events tend to be represented concretely and psychologically distant events tend to be represented abstractly. Therefore, psychological distance facilitates the creation of abstract event representations (Trope et al. 2007). In the auditing context, the event in question is the client’s preference to aggressively account for a specific transaction. We posit that a judgment framework that increases auditors’
psychological distance from the transactional details management uses to support its preferred accounting method allows auditors to gain perspective on the economics of the transaction.

Prior psychology research finds that psychological distance can be achieved by structuring individuals’ thought processes so that they think increasingly abstractly about an event (Freitas et al. 2004). Cheema and Patrick (2008) and Freitas et al. (2004) find that instructing individuals to provide a hierarchy of reasons why they would perform an action enhances the global features of the activity. This suggests that the act of considering “why” a transaction should be accounted for in a certain way at successively higher levels of abstraction will facilitate the construction of high-level construals that provide auditors with perspective on the economics of the transaction. Given that the economic substance of a transaction determines the appropriate accounting for that transaction, Construal Level Theory suggests that a framework that distances auditors from the details of the transaction that management uses to support its preferred accounting method and enhances the underlying economics of the transaction will help auditors constrain the client’s aggressive reporting.

**Auditor Judgment Frameworks**

Examples of each of the three proposed frameworks examined in this study are included in the Appendix. The first framework, the *critical evaluation framework*, is based on CIFiR’s recommendations and requires auditors to consider the pros and cons of the non-client-preferred accounting method. The second framework, the *hybrid framework*, combines the CIFiR’s suggestion to consider all of the accounting alternatives with Construal Level Theory and encourages auditors to think broadly about why the transaction should be accounted for in accordance with both the client-preferred and non-client-preferred accounting methods. We

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9 Each framework includes representative responses from actual participants. The boxes in each framework were initially empty for the participating auditors to complete.
designed the last framework, the *why framework*, to most closely follow prior research on how to create psychological distance. This one-sided framework only requires auditors to consider why the transaction should be accounted for in accordance with the alternative (rather than the client-preferred) accounting method. Our study contributes to theory and practice by examining the effectiveness of these three alternative judgment frameworks (one proposed by standard setters versus two suggested by recent developments in psychology research) when the accounting standards differ in their level of precision.

All three of the proposed frameworks attempt to expand the relevant information auditors consider when making their judgments. Prior studies find that the consideration and documentation of information consistent with the alternatives leads to more reasoned judgments that incorporate relevant information not otherwise considered (Heiman 1990; Koonce 1992; Earley et al. 2008). This suggests that an intervention that increases the availability and consideration of alternative accounting methods either through (1) the consideration of the pros and cons of the non-client-preferred accounting method (i.e., the *critical evaluation framework*) or (2) the combination of the CIFiR’s suggestion to consider all of the accounting alternatives and psychological distancing (i.e., the *hybrid framework*) or (3) the creation of psychological distance that encourages bigger picture thinking about why the non-client-preferred accounting method rather than the client-preferred accounting method should be accepted (i.e., the *why framework*) will improve judgment quality.

However, we predict that a judgment framework will be more effective at reducing aggressive reporting under less precise standards. A recent study by Maksymov et al. (2012) suggests that auditors’ judgments under less precise standards are more susceptible to the actual description of the audit task. Thus, we expect that instructing auditors to consider the alternatives
when making their judgments will have a greater impact on auditors’ judgments under less precise standards. Further, more precise accounting standards provide less latitude for management’s interpretation of the facts, as well as enforceable rules that auditors can rely on when challenging management’s aggressive reporting. Thus, as predicted in H1, auditors likely allow less (more) aggressive reporting under more (less) precise standards absent the use of a judgment framework. Accordingly, there is more opportunity for a judgment framework that expands the relevant information auditors consider when making their judgments to significantly reduce aggressive reporting under less precise standards compared to more precise standards. Therefore, we formally hypothesize the following:

H2: Auditors who use a judgment framework are less likely to allow a client’s aggressive reporting than those who do not and this effect is greater under less precise standards than more precise standards.

Relative Effectiveness of Judgment Frameworks

If a judgment framework helps auditors curb aggressive financial reporting under less precise accounting standards, it is important to understand each framework’s relative effectiveness. The CIFiR suggests that one way to increase the quality of auditors’ judgments and decisions is to consider the pros and cons of the different accounting method alternatives. Koonce (1992) explains that the requirement to think about and document counterarguments enhances the salience of these arguments, thereby reducing auditors’ belief in the validity of the client’s argument. Given that the appropriate accounting for a given transaction is driven by the economic substance of that transaction, auditors may further benefit from psychologically distancing themselves from the transactional details that support the client’s preference. Construal Level Theory suggests one way to create this distance and enhance the global features of the information is to structure auditors’ thought process so that they think increasingly
abstractly about why a transaction should be accounted for in a certain way (Freitas et al. 2004). Thus, one potential improvement to the CIFiR’s framework is to combine this mechanism for creating psychological distance with the consideration of the alternatives. Our hybrid framework does just that by asking auditors to think broadly about why the transaction should be accounted for in accordance with both of the alternative accounting methods.

We also examine the potential for our why framework that introduces psychological distance by asking auditors to only consider why the transaction should be accounted for in accordance with the non-client-preferred accounting method. This is a marked difference from both the critical evaluation and hybrid framework that both encourage a more balanced evaluation of the alternatives. Admittedly, not explicitly considering the arguments in favor of the client-preferred accounting method may make it difficult to apply this one-sided framework in practice. However, prior psychology research has only investigated the benefits of thinking increasingly abstractly about one alternative (e.g., Cheema and Patrick 2008; Freitas et al. 2004). Because Construal Level Theory has not been tested in the auditing setting, it is not clear whether psychological distancing will be more effective in combination with the consideration of the different accounting method alternatives or when only considering the non-client preferred method. However, compared to the critical evaluation framework, we do expect that auditors will benefit from the psychological distance and big picture perspective provided by the hybrid and why frameworks as evidenced by a reduction in auditors’ allowance of aggressive reporting. Thus, we formally hypothesize the following:

H3: Auditors employing the why framework and the hybrid framework are less likely to allow a client’s aggressive reporting under less precise standards than auditors using the critical evaluation framework.
III. RESEARCH METHOD

Participants

Two hundred and nineteen practicing audit managers and partners participated in this experiment using a 2 x 4 factorial design. The auditors were from one of the Big 4 firms and participated while attending firm training. All experimental materials were randomly distributed among participants.

Procedure

We adapted our case materials from Agoglia et al. (2011). All participants first read the guidelines for classifying a lease as either a capital or operating lease. Participants were told that the comparison of the lease term to the estimated economic life was the only criterion relevant to the lease classification decision. All participants were told that a lease must be classified as an operating lease if it does not meet the capital lease criterion. Half of the participants were then provided with the more precise criterion for classification as a capital lease, while the other half saw the less precise criterion. We defined lease term for all participants as the fixed non-cancelable term of the lease plus all periods covered by bargain renewal options. All participants were told that a bargain renewal option exists when the lessee has the option to renew the lease for an amount sufficiently lower than the fair rental of the property such that exercise of the option appears, at the inception of the lease, to be reasonably assured. Thus, the lease term depended on participants’ determination of whether any renewal option embedded in the lease was a bargain. Once this determination was made, participants had to use their judgment to determine whether the lease term met the criterion established in the standard for capitalization.

All participants were asked to assume that they were the auditors of ABC Company. ABC just entered into a lease for new equipment to be used to produce a new product. The
equipment has an estimated economic life of 10 years and the lease has a fixed non-cancelable term of 5 years. At the end of the initial non-cancelable term, the lease agreement provides ABC with the option to renew the lease for an additional 3-year period with the monthly rental payment to be set at 85% of the fair rental value. Participants were then told that ABC did not have a history of renewing the lease on this particular piece of equipment, but ABC did recently renew its lease on the equipment used to produce another product for a 1-year period at 85% of the fair rental value for the equipment.\textsuperscript{10} Further, the case explained that management was unsure about the decision to exercise the option to renew the lease due to the uncertainty over the success of the new product. Consequently, ABC believed that the transaction should be classified as an operating lease.

Participants were then provided with a summary of the impact of the alternative lease classifications on the company’s financial statements at the end of the first year of the lease. Participants were also told that ABC had plans to expand its plant to meet the growing demand for one of its other products. However, in order to receive a loan for this expansion, ABC’s total liabilities/total equity ratio must remain below a set threshold. Thus, the case presented very strong incentives to classify the lease as an operating lease.

After reading the classification criterion and case information described above, participants in the three framework conditions received an example of a completed judgment framework for a non-accounting task. Participants then completed a similar judgment framework for the lease classification decision. Participants in the control group (i.e., no framework) had space to make any notes that they wished regarding the specific transaction. After this task, all

\textsuperscript{10} It is important to note that we included the lack of historical precedence for renewing the lease on this specific equipment at 85% of the fair rental value for an additional 3-year period to allow for auditors’ use of their professional judgment in the determination of the lease term. However, four out of five practicing audit partners at three different Big Four audit firms agreed that the lease contained a bargain renewal option. Thus, classifying this lease as an operating lease constitutes aggressive reporting.
participants provided their lease classification decision. Finally, participants answered several post-experimental and demographic questions.

**Independent Variables**

We manipulated two independent variables: *accounting standard precision* and *judgment framework*. The first independent variable, *accounting standard precision*, was manipulated between participants. The more precise standards refer to the standards under current U.S. GAAP, while the less precise standards consist of the IFRS standards implemented internationally. FASB Accounting Standards Codification 840-10-25-1 provides specific bright-line tests that dictate the classification of a lease. Conversely, International Accounting Standard 17’s lease classification indicators do not provide any quantitative thresholds. Consistent with U.S. GAAP, the *more precise* condition required that a lease be capitalized if the lease term was “equal to 75% or more” of the estimated economic life of the leased property. In the *less precise* condition, leases were to be capitalized if the lease term was “for the major part” of the expected life. This language is consistent with Agoglia et al. (2011) and is the only language that was different between these two conditions.

We also manipulated the second independent variable, *judgment framework*, between participants. Auditors in the *no framework* condition are not required to use a formal judgment framework. The second condition, the *critical evaluation framework*, reflects regulators’ identification of the consideration of the pros and cons of the different accounting method alternatives as a key component of a well-reasoned professional judgment (CIFiR 2008). As such, we required participants in the critical evaluation framework condition to explicitly consider an alternative hypothesis (the non-client-preferred accounting method) and the pros and cons for this alternative. Our third and fourth conditions (the *hybrid framework* and the *why*
framework) based on Construal Level Theory attempt to facilitate the creation of high-level construals by structuring auditors’ thought process to think increasingly abstractly about the transaction. Following prior research (Freitas et al. 2004; Cheema and Patrick 2008), auditors in these two conditions were asked to document why the transaction should be accounted for a certain way, moving up a hierarchy of reasons to higher levels of construal. We required participants in the hybrid framework condition to think broadly about why the transaction should be accounted for in accordance with the client’s preference, as well as why the transaction should be accounted for using the non-client-preferred accounting method. This condition thus combines the CIFiR’s suggestion that auditors consider the pros and cons of the different accounting method alternatives and Construal Level Theory’s psychological distancing. Because prior research has only tested this abstract thinking in a setting where only one alternative is considered (Freitas et al. 2004; Cheema and Patrick 2008), it is not clear whether psychological distancing will be effective in combination with the consideration of both of the alternative accounting methods. Thus, our final condition (the why framework) attempts to psychologically distance auditors from the client’s preference by asking them to only consider accounting for the transaction in accordance with the non-client preferred method.

**Dependent Variable**

Our main dependent variable is auditors’ lease classification decision on a scale from 1 (definitely classify as operating lease) to 10 (definitely classify as capital lease). While audit staff and seniors are actively involved as members of the audit team in researching the issue and building the argument to put before the client, audit managers and partners ultimately decide on the appropriateness of the client-preferred method. Consequently, of interest is the likelihood that
our audit manager and partner participants would require the lease to be classified as an operating lease or as a capital lease.

IV. RESULTS

Descriptive Statistics

Two hundred and nineteen audit managers and partners participated in our study. To verify that our participants attended to our manipulation of the applicable accounting standard, the post-experimental questionnaire asked participants to identify the criterion they needed to consider in classifying a lease as a capital lease or an operating lease. Ninety-nine percent of the participants in the more precise condition and 84 percent of participants in the less precise condition correctly identified the applicable criterion. We excluded those 18 participants that failed this manipulation check. To verify that our participants attended to our manipulation of the judgment framework, one of the authors reviewed the completed case materials. We excluded an additional seven participants that failed to complete their respective framework, leaving 194 practicing audit managers and partners in our sample. They have an average of approximately 9.0 years (108.5 months) of audit experience which does not differ between the more and less precise accounting standards conditions ($t_{187} = 0.399, p = 0.690$). Their participation in IFRS filings also does not differ between these conditions ($t_{192} = 0.098, p = 0.922$): Only 56 out of 194 participants had participated in an IFRS filing, with 30 of these participants in the more precise condition and 26 in the less precise condition.

Tests of Hypotheses

Consistent with Agoglia et al. (2011), auditors recorded their lease classification decisions on a forced-choice scale where higher (lower) values indicate a higher likelihood that
they would require classification as a(n) capital (operating) lease. We use a 2 x 4 ANOVA (accounting standard precision x judgment framework) to test our hypotheses. Panel A of Table 1 contains cell means and Panel B presents the ANOVA results. To further explore the effect of accounting standard precision and the use of a judgment framework, we dichotomize auditors’ responses at the midpoint to create a practical measure of auditors’ lease classification decision. Table 2 presents both the raw number and percentage of auditors requiring capital lease classification in each condition.

[Insert Tables 1 and 2 here]

**Auditors’ Judgments and Accounting Standard Precision**

Our first hypothesis examines auditors’ reporting decisions under more and less precise accounting standards absent the use of a judgment framework. In H1, we predict auditors’ judgments under less precise standards lead to more aggressive reporting. As indicated in the hypothesized contrast testing in Panel C of Table 1, auditors are more likely to allow the lease to be classified as an operating lease (the client-preferred classification) when operating under a less precise standard (mean = 4.42) than a more precise standard (mean = 5.75, F_{1,186} = 3.18, one-tailed p = 0.038). These results are consistent with auditors’ dichotomized classification decision presented in Table 2 which shows only 26 percent of auditors in the less precise condition classified the lease as a capital lease compared to 57 percent in the more precise condition (χ²_{(1)} = 4.35, one-sided p = 0.019). Thus, H1 is supported suggesting that less precise accounting standards alone (i.e., IFRS) will not curb auditors’ propensity to allow aggressive reporting.

To further explore the effect of accounting standard precision on auditors’ judgments, we analyze participants’ beliefs about their power to resolve a conflict with their audit client and
their interpretation of the facts of the lease. In the post-experimental questionnaire, participants indicated how much power the lease classification criterion used in this case provides in resolving auditor-client conflicts on a 7-point Likert scale (1 = no power, 7 = complete power) and the extent to which the option to renew the lease at the end of the lease term represents a bargain (1 = not at all, 7 = definitely). Consistent with the development of H1, we find that auditors believe they have less power to resolve conflicts under less precise accounting standards (mean = 3.63) than more precise standards (mean = 4.64, t_{45} = 2.188, one-tailed p = 0.017). This finding is consistent with auditors’ concerns that they will have less power during negotiations with the client to curb management’s aggressive reporting under less precise IFRS. Additionally, we find that auditors are more likely to classify the lease as operating when they interpret the facts of the case to suggest that a bargain renewal option does not exist (Pearson r = 0.736, one-tailed p = 0.000). Together, these findings suggest that auditors’ ability to curb aggressive reporting under less precise accounting standards is hindered by the lack of precise guidance that provides more latitude for management’s interpretation of the facts while making it more difficult for auditors to oppose the preferred accounting method.

**Use of a Judgment Framework to Curb Aggressive Reporting**

Our second and third hypotheses explore the ability of a judgment framework to help auditors curb management’s aggressive reporting. Because all three of the proposed frameworks attempt to expand the relevant information auditors consider when making their judgments, H2 predicts that auditors who use a judgment framework are less likely to allow a client’s aggressive reporting than those who do not. However, given that the evidence related to H1 suggests that auditors are less likely to allow aggressive reporting under more precise standards, there is less opportunity for a judgment framework to reduce aggressive reporting under more precise
standards compared to less precise standards. As such, H2 predicts that the use of a judgment framework helps auditors more under less precise standards than more precise standards. The results of the hypothesized contrast in Panel C of Table 1 support this interaction ($F_{1,186} = 4.68$, one-tailed $p = 0.016$). In particular, while auditors who use a judgment framework under less precise standards are less likely to allow aggressive reporting ($F_{1,186} = 12.85$, one-tailed $p < 0.001$), the use of a judgment framework does not help auditors constrain aggressive reporting under more precise standards ($F_{1,186} = 0.75$, one-tailed $p = 0.194$). Further support for H2 comes from auditors’ dichotomized classification decisions presented in Table 2. In particular, 57 percent of auditors not using a judgment framework under more precise standards classified the lease as a capital lease compared to 60 percent of auditors using any framework ($\chi^2_{(1)} = 0.06$, one-sided $p = 0.406$). Under less precise standards, the use of a judgment framework resulted in significantly more auditors capitalizing the lease (71 percent vs. 26 percent, $\chi^2_{(1)} = 12.88$, one-sided $p < 0.001$).

Our third hypothesis examines the effectiveness of the specific judgment frameworks under less precise accounting standards. Under less precise accounting standards where there is more opportunity for a judgment framework to help, H3 predicts that auditors will benefit incrementally from the creation of psychological distance. More specifically, we predict that auditors employing the hybrid or the why framework are less likely to allow a client’s aggressive reporting under less precise standards than auditors using the critical evaluation framework. Consistent with this hypothesis, the results detailed in Panel C of Table 1 provide evidence of the incremental benefits of psychological distancing ($F_{1,186} = 6.12$, one-tailed $p = 0.007$). Further

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11 To test this interaction, we use a contrast weight of +3 when auditors do not use a framework and -1 for the three framework conditions under more precise standards. Under less precise standards, we use a contrast weight of -3 when auditors do not use a framework and +1 for the three framework conditions.

12 We use a contrast weight of -2 when auditors use the critical evaluation framework under less precise standards and +1 for both the hybrid and why framework conditions.
analysis indicates that the hybrid framework (mean = 7.48) is just as effective as the why framework (mean = 7.08) at helping auditors curb aggressive reporting under less precise accounting standards ($F_{1,186} = 0.30$, one-tailed $p = 0.292$). Additionally, compared to the critical evaluation framework (mean = 5.68), those auditors employing the hybrid framework ($F_{1,186} = 5.77$, one tailed $p = 0.009$) and the why framework ($F_{1,186} = 3.64$, one tailed $p = 0.029$) are less likely to allow aggressive reporting. Auditors’ dichotomized classification decisions presented in Table 2 further support H3. Significantly more auditors employing the hybrid or the why framework (77 percent) classify the lease as a capital lease under less precise standards than auditors using the critical evaluation framework (59 percent, $\chi^2 (1) = 2.39$, one-sided $p = 0.061$).

Thus, we present evidence that a framework based on CIFiR’s recommendations has the potential to improve auditors’ judgments as we move towards less precise accounting standards, but the effectiveness of such a framework may be enhanced through a modification based on Construal Level Theory that creates psychological distance and fosters big picture thinking.  

**Additional Analyses**

It is also important for us to examine the usefulness of the specific judgment frameworks under more precise accounting standards as auditors in practice are currently operating under both more and less precise standards. Untabulated analyses indicate that auditors operating under more precise standards are less likely to allow the lease to be classified as an operating lease (client-preferred classification) when auditors employ a why framework (mean = 7.00) compared

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13 We also ran an experiment with 200 staff and senior auditors from the same Big 4 firm examining the benefits of judgment frameworks under less precise IFRS. We used a contextually rich lease classification task to examine auditors’ allowance of aggressive reporting. Further, participants were provided with the actual verbiage from FASB Accounting Standards Codification 840-10-25-1 in the more precise condition and the actual verbiage from International Accounting Standard (IAS) 17 in the less precise condition. Similar to the findings in this study, we find that a judgment framework based on Construal Level Theory is most effective in helping auditors curb aggressive reporting under less precise standards. The results of that experiment provide corroborating evidence to the results reported in this study and suggest that judgment frameworks based on Construal Level Theory will also be helpful to less experienced members of the engagement team.
to when they do not use any judgment framework (mean = 5.75), use the critical evaluation framework (mean = 5.43), or use the hybrid framework (mean = 6.26, F1,186 = 4.37, one-tailed p = 0.019). Further, the likelihood that auditors allow aggressive reporting does not significantly differ across these three conditions—no framework, critical evaluation framework, and hybrid framework (all F1,186 ≤ 1.391, all two-tailed p ≥ 0.240). Analysis of auditors’ dichotomized classification decision presented in Table 2 is consistent with the above analyses. When operating under more precise accounting standards, significantly more auditors classified the lease as a capital lease after completing the why framework (73 percent vs. 54 percent, χ²(1) = 2.81, one-sided p = 0.047). Thus, auditors employing the why framework are less likely to allow a client’s aggressive reporting under more precise standards than auditors using no framework, the critical evaluation framework, or the hybrid framework. This suggests that in order to effectively help auditors constrain aggressive reporting under more precise standards, a framework needs to both distance auditors from the client’s preference and ask auditors to focus only on whether the non-client-preferred method best captures the big picture economics of the transaction.

V. CONCLUSION

In this paper, we investigate the effect of alternative judgment frameworks on auditors’ propensity to allow aggressive reporting under both less and more precise accounting standards. Our study is motivated by concerns regarding the quality of auditors’ judgments in light of the convergence towards accounting standards that are more general and provide less guidance (FASB 2010; FASB 2013). These concerns prompted a call for guidance in making and

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14 We test this using a contrast weight of -3 when auditors use the why framework under more precise standards and +1 for the other three conditions.
evaluating auditors’ judgments (CIFiR 2008). However, regulators, standard setters, and auditors do not know how judgment frameworks based on this guidance will affect the overall quality of auditors’ judgments.

Consistent with our expectations, our results indicate that auditors are more likely to allow aggressive reporting under less precise accounting standards. These results corroborate the standard setters’ concerns about auditors’ constraint of aggressive reporting and failure to use sound professional judgment when the accounting standards lack precise guidance (FASB 2004; SEC 2008). Importantly, we also find that auditors employing a judgment framework are more likely to curb such aggressive reporting. The effectiveness of the different judgment frameworks depends on the precision of the accounting standards. A framework based on the guidance of the SEC’s CIFiR to consider the pros and cons of alternative hypotheses is effective in helping auditors curb aggressive reporting under less precise standards. However, we find evidence that supports a modification to CIFiR’s guidance that may enhance auditors’ skepticism. Both of our judgment frameworks based on Construal Level Theory that psychologically distance auditors from the transactional details that management interprets as supporting its preferred accounting method help auditors constrain aggressive reporting under less precise standards. Further, the creation of psychological distance when asking auditors to only consider the non-client-preferred method effectively enhances auditors’ skepticism under more precise standards where there is less opportunity for a judgment framework to help. In sum, these results support regulators’ efforts to develop judgment guidance for auditors, but suggest potential incremental benefits of considering theory-based judgment frameworks that go beyond considering an alternative’s pros and cons.
Our study makes several contributions to research and practice. We find evidence supporting the concerns expressed by regulators and others regarding auditors’ constraint of aggressive reporting under less precise accounting standards. Our finding that auditors are more likely to allow aggressive reporting under less precise standards because they feel less powerful in client negotiations is important as we converge towards a less precise, global set of accounting standards. We contribute to the auditor judgment literature by providing experimental evidence on the ability of a judgment framework to improve audit quality. The judgment frameworks bolster auditors’ ability to constrain management’s aggressive reporting by expanding the arguments the auditor considers that counter the client’s aggressive reporting preference. However, because we find evidence that the critical evaluation framework is only effective under less precise standards, our study highlights a possible limitation of the proposed auditor judgment guidance for improving auditors’ judgments in the current U.S. GAAP environment. Further, our reliance on Construal Level Theory suggests a modification to the guidance proposed by CIFiR that may help under both more precise and less precise standards. Our study is therefore informative to academics, regulators and auditors considering the costs and benefits of proposed auditor judgment guidance for auditors faced with accounting standards that differ in their level of precision.

A limitation of our study is that it examines a context where big picture thinking improves the quality of auditors’ judgments and increases auditors’ propensity to curb aggressive reporting. In particular, we find that frameworks that facilitate the creation of high-level construals that focus on the overall economics of the transaction enhance auditors’ skepticism when evaluating the accounting treatment for a given transaction. However, there are other audit tasks where auditors stand to benefit from the creation of low-level construals that focus on the
low-level details (see Backof et al. 2013). Further, while we examine a setting where there are only two ways to account for a transaction, more alternatives may exist in different settings. Our results suggest that these other scenarios are areas for future research.
REFERENCES


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_____, and M. Mercer. 2012. Are juries more likely to second-guess auditor judgment under imprecise accounting standards? Working paper: Emory University and DePaul University.


TABLE 1

Auditors’ Lease Classification Likelihood

Panel A: Lease Classification Likelihood

<table>
<thead>
<tr>
<th>No Critical Evaluation Framework</th>
<th>Hybrid Framework</th>
<th>Why Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>More Precise Accounting Standard</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean (SE) [N] Cell</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.75 (0.519) [28]</td>
<td>6.26 (0.633) [23]</td>
<td>7.00 (0.444) [26]</td>
</tr>
<tr>
<td>5.43 (0.486) [28]</td>
<td>6.09 (0.262) [105]</td>
<td></td>
</tr>
<tr>
<td>Less Precise Accounting Standard</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean (SE) [N] Cell</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.42 (0.569) [19]</td>
<td>7.48 (0.495) [23]</td>
<td>7.08 (0.454) [25]</td>
</tr>
<tr>
<td>5.68 (0.462) [22]</td>
<td>6.27 (0.272) [89]</td>
<td></td>
</tr>
<tr>
<td>5.21 (0.393) [47]</td>
<td>6.87 (0.407) [46]</td>
<td>7.04 (0.314) [51]</td>
</tr>
</tbody>
</table>

Panel B: Two-way ANOVA Results

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>two-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard</td>
<td>1</td>
<td>0.15</td>
<td>0.02</td>
<td>0.879</td>
</tr>
<tr>
<td>Framework</td>
<td>3</td>
<td>44.31</td>
<td>7.05</td>
<td>0.000</td>
</tr>
<tr>
<td>Standard * Framework</td>
<td>3</td>
<td>12.57</td>
<td>2.00</td>
<td>0.116</td>
</tr>
<tr>
<td>Error</td>
<td>181</td>
<td>6.29</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Panel C: Tests of hypotheses

<table>
<thead>
<tr>
<th>Planned Contrasts</th>
<th>F_{1,186}</th>
<th>one-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1: Without a judgment framework, auditors are more likely to allow aggressive reporting under less precise accounting standards compared to more precise standards. Test: E &lt; A</td>
<td>3.18</td>
<td>0.038</td>
</tr>
<tr>
<td>H2: Auditors who use a judgment framework are less likely to allow a client’s aggressive reporting than those who do not and this effect is greater under less precise standards than more precise standards. Test: [A &lt; (B+C+D)/3] &lt; [E &lt; (F+G+H)/3]</td>
<td>4.68</td>
<td>0.016</td>
</tr>
<tr>
<td>H3: Auditors employing the why framework and the hybrid framework are less likely to allow a client’s aggressive reporting under less precise standards than auditors using the critical evaluation framework. Test: F &lt; (G+H)/2</td>
<td>6.12</td>
<td>0.007</td>
</tr>
</tbody>
</table>

Participants indicated the likelihood they would require the lease to be classified as either an operating lease or a capital lease using a ten-point scale numbered from 1 “Definitely classify as an operating lease” to 10 “Definitely classify as a capital lease”.

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### TABLE 2

**Auditors' Lease Classification Decision**

<table>
<thead>
<tr>
<th>Lease Classification Decision</th>
<th>Number of Capital Leases (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Framework</td>
</tr>
<tr>
<td>More Precise</td>
<td></td>
</tr>
<tr>
<td></td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>57.1%</td>
</tr>
<tr>
<td>Less Precise</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>26.3%</td>
</tr>
<tr>
<td></td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>44.7%</td>
</tr>
</tbody>
</table>

Participants’ ten-point likelihood responses were dichotomized at the midpoint such that responses of 1 to 5 on the scale are classified as Operating Lease (0) and responses of 6 to 10 are classified as Capital Lease (1).
Please complete the framework for ABC Company’s equipment lease classification decision.

**Issue:** There are two alternative accounting treatments for this transaction: (1) classify the transaction as an operating lease (client-preferred) or (2) classify the transaction as a capital lease.

Consider the pros and cons of requiring the lease to be classified as a capital lease as opposed to an operating lease.

**Pros:**

- Capital lease accounting is more transparent
- History of exercising renewal option
- Greater tax deduction (interest & depreciation) in earlier years of lease

**Cons:**

- Presented as an asset/liability: can't meet debt covenant
- Capital lease accounting is more complex
- Hurt client relationship
Please complete the framework for ABC Company’s equipment lease classification decision.

Better presentation on the financial statements.

**Even more broadly, why would you require the lease to be classified as a capital lease as opposed to an operating lease?**

ABC has been a public company with good past history with its first product. It is likely that the company will be successful with product y.

**Thinking more broadly, why would you require the lease to be classified as a capital lease as opposed to an operating lease?**

At inception, there’s previous evidence that the Company exercises renewal options for its products.

**Why would you require the lease to be classified as a capital lease as opposed to an operating lease?**

**Issue:** There are two alternative accounting treatments for this transaction: (1) classify the transaction as an operating lease (client-preferred) or (2) classify the transaction as a capital lease.
Please complete the framework for ABC Company’s equipment lease classification decision.

Issue: There are two alternative accounting treatments for this transaction: (1) classify the transaction as a capital lease or (2) classify the transaction as an operating lease (client-preferred).