

# **An Experimental Analysis of Accounting Judgments between US GAAP and IFRS Accountants**

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*Abstract:* European and U.S. based accountants will be given a case experiment requiring an accounting judgment. We hypothesize that the U.S. accountants will be more conservative than their European counterparts in applying judgments under uncertainty. As the U.S. moves toward the adoption of international accounting standards, which are more principle than rule based, the importance of judgments in decision-making and their financial statement impact will increase.

Key words: accounting, judgment, IFRS, GAAP, decision making

## **Introduction**

Accounting is often described as the language of business and as such, accounting is the means by which organizations communicate their financial position. Just as different countries have developed their own conversational languages, over the years countries have also developed their own accounting “languages” or standards. Two sets of accounting standards having substantial economic “clout” throughout the globe are the United States Generally Accepted Accounting Principles (‘U.S. GAAP’) and International Financial Reporting Standards (IFRS). Since 2002, the capital markets, global public accounting professional firms, and multinational corporations have recognized the benefits of a single set of global accounting standards. A single global accounting standard would facilitate financial comparisons of companies based in different countries, increase audit efficiency, and enable easier transfer of top accounting talent worldwide, (Fosbre, Kraft and Fosbre 2009).

Although U.S. GAAP and IFRS are based on the same underlying general accounting principles and conceptual framework and often application of either standard will produce the same accounting results, there are significant differences in the standards as well as the approach for standard setting. U.S. GAAP, although grounded in principles, is considered to have a “rule based approach”. These differences in approach have resulted in U.S. GAAP having specialized accounting standards and interpretations of standards by industry while IFRS typically does not. U.S. GAAP is also considered more conservative than IFRS in that U.S. GAAP often delays revenue recognition and accelerates the recognition of potential liabilities, (Ernst & Young, 2009).

This proposed research would use an experimental research setting to examine the differences of accounting judgments between U.S. trained accountants versus European Union (EU) accountants when applying an accounting judgment in a situation where there is not a

bright line right or wrong answer. Since EU accountants have practiced longer in an environment that relies strongly on auditor judgment (IFRS), will their judgments be different from U.S. accountants when faced with the same circumstances? Although there are published studies analyzing the empirical impact of convergence of accounting standards on U.S. company financial statements, this research will advance knowledge by furthering the understanding of the judgment process and resulting outcomes when trained under a rule based versus principled approach. In addition, additional training in judgment and decision-making may be suggested for U.S. accountants prior to full implementation of IFRS as summarized by Joel Osnoss, lead partner, Deloitte and Touche Global IFRS and Offering Services, who stated: “While there will be much change, the biggest change for CFOs and companies, will be around getting people to get off the bright-line bandwagon and really starting to think about judgments.”<sup>1</sup>(Marshall, 2008).

## **Literature Review**

There has been limited research on the impact of accounting judgments under uncertainty when faced with principle guidance versus prescriptive. In fact, in the prior literature that exists, there is conflicting research results when accounting judgments are made based on “rule based” versus “principle based” standards. Cuccia, Hackenbrack and Nelson (1995) found that stringent numerical tax standards did not result in less aggressive tax judgments than vague verbal standards, while research by Psaros and Trotman (2004) found that when incentives are held equal, the “rules based” standards resulted in more aggressive accounting than the “substance over form” standards.

## **Theory and Hypothesis Development**

In a ten year perspective on positive accounting theory, Watts and Zimmerman (1990) reviewed literature that explained accounting as a nexus of contracts, social, political, economic, environmental etc. in which individuals rationally make decisions based on their own self interests. Positive accounting theory has generated a lot of empirical research by providing evidence supporting the understanding of actual managerial behavior in judgment choice. Prospect theory adds a psychological or behavioral element to positive accounting decision-

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<sup>1</sup> [http://www.thefreelibrary.com/editor's page.-a0180271705](http://www.thefreelibrary.com/editor's+page.-a0180271705).

making theory. In the empirical research supporting positive accounting theory, researchers observed individuals may not always act in a rational manner based on known information particularly when there was uncertainty in outcomes. Kahneman and Tversky (1979) found individuals making decisions under the risk of uncertain outcomes will overestimate the probabilities of the negative outcomes while underestimating the risk of the positive outcomes. These “errors” in maximization of utility gains make positive accounting experimental research important in analyzing the behavior of actual accountants.

U.S. accountants and U.S. GAAP are generally considered to be more conservative due to the litigious nature of the U.S. legal environment. U.S. accountants prefer a bright line rule in decision making rather than using professional judgment. Judgments may result in different accountants reaching different conclusions, all of which are supportable but potentially problem areas in litigation. Since prospect theory suggest that individuals will overestimate the probability of negative outcomes, we posit that U.S. accountants will overestimate the risk of legal liability and will be more conservative in preparing financial statements than their European accountant counterparts. In addition, U.S. accountants have less experience and thus increased uncertainty in applying judgment in accounting decisions; therefore, the following is hypothesized:

H1: U.S. accountants (European accountants) will be less likely (more likely) to delay an annual expense to increase current year income.

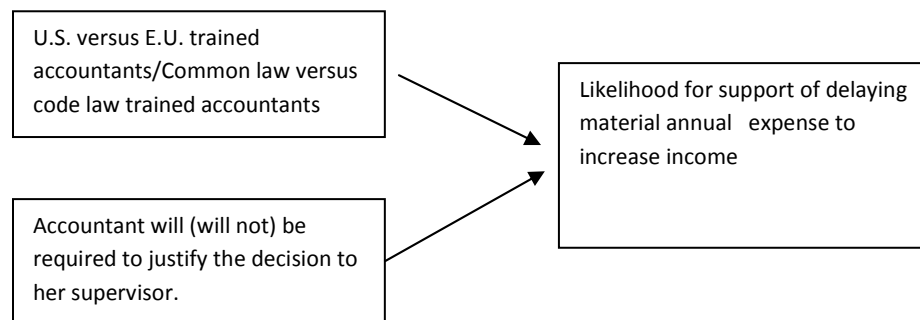
The EU is composed of both common law and code-law countries. Common law countries, such as the United Kingdom, have legal environments that are geared toward the protection of the public investor due in part to the wide dispersion of ownership of companies found in those countries. In contrast, code-law countries such as France and Germany have legal environments that are heavily influenced by governments, banks and labor unions, insiders rather than outsiders due in part to the closely held ownership of companies found in those countries. Ball, Kothari and Robin (2000) found that accounting judgments were more conservative in common law countries rather than code law countries. Since insiders dominate firm ownership in code-law countries, methods to become aware of potential gains and losses are already available to the insider investor. Therefore, it seems reasonable to posit that countries with code law ownership orientations will be less conservative in their accounting judgments versus their common law counterparts. This leads to the second hypothesis:

H2: Accountants from common law (code law) countries where ownership of firms is widely dispersed (closely held) will be less likely (more likely) to delay an annual expense to increase current year income.

Schlenker, Britt, Pennington, Murphy and Doherty (1994) refer to accountability as occurring when an individual or organization has responsibility for a judgment or decision. The individual or organization is held responsible and judged by the stakeholders of that decision. If an individual could have and should have made a different decision with a better outcome for the stakeholders, that individual will be held accountable. Accountability is the mechanism for consequences resulting from an unfavorable outcome. Tetlock (1985) and Tetlock and Zanna (1992) showed accountable decision makers are motivated by the realization they may have to justify their decision to others; therefore, they use more cognitive decision making processes in reaching their judgments. Therefore, we posit that accountants required to justify their decision will be less likely to delay a material annual recurring expense.

H3: Accountants required to justify their decision to a supervisor will be less likely to delay an annual expense to increase current year income.

### Model



## **Research Method**

A 2 X 2 research experimental case design is proposed. An earnings management case previously developed and tested using accounting students would be given to two groups of accountants, U.S. accountants and E.U. accountants, see Clikeman and Henning (2000). Translation services will be performed on the case by translating the case to the applicable language of the respondent and then retranslating the case back to English to verify the case is correctly interpreted in the applicable language. We will either use an online survey or a mail survey. Either way, second requests will be mailed two weeks after the original request to recipients who have not yet responded. . We will analyze the responses from the 1<sup>st</sup> request to those from the 2<sup>nd</sup> request to verify there are no significant differences due to environmental or situational differences in timing between the 1<sup>st</sup> request and the 2<sup>nd</sup> request. We will include a manipulation check in the demographic section of the survey to verify the respondent read the case.

The independent hypothesized variables would be U.S. or E.U. accountant and common law versus code law accountant as well as manipulating whether the accountant was required to justify the decision to her supervisor. Control independent variables would include experience, country, age, education, licenses, and industry. The dependent variable would be measured on a Likert type scale as to the degree of accountant support for or opposition to delaying a material recurring annual expense.

Descriptive statistics will be analyzed using SPSS software. First, we will examine our data looking for outliers and missing data. Next, we will run one tail t tests to verify the manipulations are in the direction hypothesized and if the results are significant. An ANOVA will enable us to partial out the explanatory variances explained from multiple independent variables. Post hoc Scheffe tests will be performed to analyze which comparisons among groups have significant differences.

## **Conclusion**

This research will provide guidance to the capital markets and companies during the convergence of accounting systems between the United States GAAP and IFRS. If U.S. accountants using the same standards still make more conservative accounting judgments, the financial statements of U.S. based companies will continue to be different from their European counterparts even though prepared under the same standards.

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