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Principles-Based versus Rules-Based Accounting Standards: The Influence of Standard Precision and Audit Committee Strength on Financial Reporting Decisions

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ABSTRACT: Recent accounting scandals have resulted in regulatory initiatives designed to strengthen audit committee oversight of corporate financial reporting and have led to a concern that U.S. GAAP has become too rules-based. We examine issues related to these initiatives using two experiments. CFOs in our experiments exhibit more agreement and are less likely to report aggressively under a less precise (more principles-based) standard than under a more precise (more rules-based) standard. Our results also indicate that CFOs applying a more precise standard are less likely to report aggressively in the presence of a strong audit committee than a weak audit committee. We find no effect of audit committee strength when the standard is less precise. Finally, we find support for a three-path mediating model examining mechanisms driving the effect of standard precision on aggressive reporting decisions. These results should be of interest to U.S. policymakers as they continue to contemplate a shift to more principles-based accounting standards (e.g., IFRS).

Keywords: *standard precision; rules-based standards; principles-based standards; audit committee; IFRS*.

Data Availability: *Contact the authors.*

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I. INTRODUCTION

Our study examines the effect of accounting standard precision on financial statement preparers' reporting judgments, as well as the potential role that the audit committee plays in mitigating aggressive financial reporting under differing levels of standard precision.[1] A wave of corporate accounting scandals in recent years has led to a push for regulatory changes. As part of the Congressional plan to reform U.S. financial reporting, the Sarbanes-Oxley Act of 2002 (SOX, U.S. House of Representatives 2002) introduced major regulatory initiatives in an attempt to overhaul financial reporting and corporate governance systems. These initiatives include two remedies aimed at dampening aggressive financial reporting: (1) the potential adoption of principles-based accounting standards and (2) enhancement of public company audit committees.

Concern has been rising within the financial/investing community that U.S. accounting standards have become too "rules-based." With bright-line tests and detailed guidance, U.S. standards have become so precise that many feel they invite opportunistic interpretation by corporate executives. The perception that a significant number of executives have been concerned with meeting the letter of a rule, more so than its spirit, has led to a call to consider a more "principles-based" regime. Accordingly, SOX required the Securities and Exchange Commission (SEC) to conduct a study on the possible adoption of principles-based standards by the U.S. financial reporting system. Recently, the SEC moved the principles-versus-rules debate to the front burner by proposing a roadmap that could lead to the mandatory adoption of the more principles-based International Financial Reporting Standards (IFRS) by U.S. public companies (SEC 2008).[2]

Additionally, the Financial Accounting Standards Board (FASB) issued a proposal for a principles-based approach to U.S. standard-setting and asked interested parties to comment (FASB 2002). Many who responded were supportive of a principles-based model, believing that such an approach would lead to higher quality financial reporting with less opportunity to "exploit the gaps in GAAP" (CalPERS) or use "financial accounting engineering" to get around detailed, rules-based standards (PricewaterhouseCoopers).[3] Conversely, some argued that less specificity in accounting standards would result in an increase in manipulation of financial results (e.g., Intel and former FASB member David Mosso). On the separate issue of inter-firm comparability, a number of letter-writers expressed concern that, with an increased reliance on judgment, implementation of principles-based standards could result in a decrease in comparability across firms (e.g., IBM, Pfizer, Goldman Sachs, BDO Seidman). The ongoing debate over whether and when to move toward more principles-based accounting standards reflects the uncertainty of both the anticipated desirable and undesirable effects of such a paradigm shift. Although these are empirical questions that can be addressed experimentally to inform policy makers prior to making a move to principles-based standards, the academic literature is limited with respect to research regarding these uncertainties (Maines et al. 2003).

As noted, the possible adoption of principles-based financial reporting standards is only one of the regulatory remedies embodied in SOX to improve U.S. financial reporting. Section 301 of SOX also expands the responsibilities of the audit committee and places greater focus on its role in enhancing the quality of financial reporting. Section 407 requires public companies to disclose

[1] Similar to Hackenbrack and Nelson (1996), we define aggressive financial reporting as the favorable portrayal of a company's financial situation even when that reporting is not clearly indicated by the facts.

[2] On February 24, 2010, the SEC issued a statement reaffirming its support for global accounting standards while pushing back the earliest date for adoption of IFRS to 2015 (SEC 2010).

[3] For example, several organizations including Computer Sciences Corporation, PricewaterhouseCoopers, and Financial Executive International made comments indicating that a principles-based approach would result in transactions being accounted for according to their economic substance rather than their form (see the FASB website for these and other comment letters: http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage?project_id=1125-001).

whether at least one member of the audit committee is a financial expert. Archival studies have shown audit committee strength to have an effect on the financial reporting process in rules-based standards environments (Klein 2002; Bédard et al. 2004). However, evidence on its effect in more principles-oriented environments and on the interactive effect of standard precision and audit committee strength is lacking (Libby et al. 2002).

To explore these issues, we conduct two experiments in which experienced U.S.-based financial statement preparers are placed in a lease classification decision context. We manipulate standard precision between participants, where more precise and less precise standards are based on FASB Statement No. 13 and International Accounting Standard (IAS) 17, respectively. Audit committee strength is manipulated between participants as either strong or weak.

The results of experiment 1 indicate that financial statement preparers are less likely to report aggressively (i.e., they are more likely to capitalize the lease) when applying a less precise (more principles-based) lease classification criterion than when applying a more precise (more rules-based) criterion. This result provides support for the SEC's and FASB's hope that a move toward more principles-based standards could result in better, or less aggressive, financial reporting. Consistent with prior archival research, we also find that preparers asked to apply a more precise standard are less likely to report aggressively in the presence of a strong audit committee than in the presence of a weak audit committee. However, we find that the influence of a strong audit committee diminishes in the principles-based setting. Interestingly, we find significantly less variability among preparers' reporting decisions when a less precise standard is in place. This suggests that, contrary to the concern of some interested parties, the application of more principles-based standards need not result in less comparability than more precise standards. Experiment 2 confirms the findings of experiment 1 and finds support for a three-path mediation model. Specifically, we find that the less precise the standard, the more concerned preparers are about second-guessing and possible costs imposed through regulation and litigation. This, in turn, results in an increased desire to reflect the underlying economics of transactions and events in the financial statements and, ultimately, in less aggressive reporting.

The findings of our study suggest a number of important implications. For example, these findings should be of interest to policy makers as they contemplate whether and when to adopt IFRS. Our results have encouraging implications for U.S. financial reporting for a move to a more principles-based accounting standards model. Also, our study provides insight regarding recent regulatory changes that address the role and composition of audit committees. Our results suggest that, under certain circumstances, principles-based standards can ease the burden on an audit committee (whether strong or weak) to curtail management's aggressive reporting choices.

Section II provides background information and develops our hypotheses. Sections III and IV describe the experiments used to test hypotheses and present the results. Section V provides a summary and offers conclusions, implications, and suggestions for future research.

II. BACKGROUND AND HYPOTHESES

Principles-Based versus Rules-Based Accounting Standards

The Current Environment

Much of the recent interest in IFRS is predicated on the notion that these standards are principles-based, whereas U.S. GAAP is described as (and often criticized for) being rules-based. Rules-based standards typically provide very detailed guidance with bright-line tests. A perceived benefit of more detailed implementation guidance is greater comparability of financial statements across companies (Schipper 2003). On the other hand, it has been suggested that rules-based standards lead to a "show me where it says I can't" attitude, which, in turn, can lead to dysfunctional financial reporting behavior (Weil 2002, 3). Excessively detailed reporting guidance can invite transaction structuring and incentive-consistent standard interpretation to achieve preferred accounting treatments (FASB 2002; Bockus et al. 2003; Nelson 2003).

The FASB's Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases*, with its detailed list of criteria for lease classification containing several bright-line thresholds, is cited as the "poster child" for rules-based standards (Maines 2007, 360). In developing SFAS No. 13, the FASB had hoped that explicit lease classification rules would eliminate individual judgment, resulting in consistent application of the standard across firms (Shortridge and Myring 2004). However, because bright-line tests were established, companies have been able to structure and interpret lease contracts to avoid capitalization, which tends to present a more favorable picture of a company's overall financial condition (Imhoff and Thomas 1988; Pulliam 1988). As a result, "the explicit rule allows the off balance sheet financing to continue, *and provides justification for the treatment*" (Shortridge and Myring 2004, 3; emphasis added).

Principles-based standards, which provide limited interpretive and implementation guidance, are the perceived solution to problems caused by rules-based standards. Less guidance, in theory, increases the need to apply professional judgment consistent with the intent of the standards. Both the FASB (2002) and the SEC (2003) believe that this will ultimately result in more meaningful and informative financial statements.[4]

Related Research

Several experimental studies have explored auditor judgments in light of specific accounting standards or guidance (e.g., Gibbins et al. 2001; Ng and Tan 2003; Kadous et al. 2003).[5] For example, Ng and Tan (2003) find that, in the presence of a weak audit committee, auditors are more likely to allow aggressive revenue recognition when no guidance/rule governs the transaction than when there is authoritative guidance specifying the appropriate reporting treatment. Trompeter (1994) finds that, when authoritative guidance limits the range of acceptable accounting treatments, audit partners are less influenced by client preferences. In an imprecise standard context, Hackenbrack and Nelson (1996) show that auditors approve reporting decisions that are consistent with their incentives and use the vagueness of the imprecise standard to justify their decisions. While these studies provide some evidence as to how *auditors* react to the existence or specificity of authoritative guidance, they assume, either implicitly or explicitly, that managers will always choose to report aggressively. This line of research does not speak to how standard precision influences the level of aggressiveness in reporting decisions of financial statement *preparers*.

Three studies have employed an experimental approach to examine the influence of standard precision on reporting decisions made by financial statement preparers (Hoffman and Patton 2002; Psaros and Trotman 2004; Jamal and Tan 2010). Hoffman and Patton (2002) hypothesize that less precise standards for governmental financial reporting provide more latitude for federal financial

[4] Specifically, the FASB (2002) concludes that adopting a principles-based approach will result in greater judgment, leading to: accounting treatments that conform to the substance of a transaction, improved transparency, enhanced comparability, increased responsiveness to emerging accounting issues, and facilitation of international financial reporting standard convergence.

[5] Cuccia et al. (1995) explore rule precision in a *tax* setting, finding that moving from a vague rule to a more precise rule has no effect on tax practitioners' propensity to take an aggressive position on an individual's return. When a vague standard exists, tax preparers use the vagueness in the standard to justify their aggressive tax position; when a precise standard exists, they use the vagueness in facts to justify their position. However, as the authors point out, results from their study of tax practitioners might not generalize to financial reporting decisions because of differences in penalties and professional responsibilities (Cuccia et al. 1995), as well as in the scope of impact (e.g., aggressive reporting in an individual tax setting affects a few people at most, limiting the financial/social impact, while aggressive financial reporting by publicly traded companies can have a much broader and deeper impact).

officers to reach reporting decisions that are aligned with their incentives. Contrary to expectations, they find that replacing a less precise recognition threshold ("probable") with a more precise threshold ("more likely than not") does not affect the likelihood that these preparers will recognize a contingent loss. They speculate that the lack of an effect could be due to a weak manipulation, as participants did not appear to perceive the new threshold to be more precise than the original.

Using two separate experiments involving a consolidation judgment, Psaros and Trotman (2004) consider whether corporate accountants will justify aggressive judgments by more aggressively interpreting case-specific information. Results of the first experiment, conducted in a "substance-over-form" (less precise) standard setting, suggest that accountants who make more aggressive judgments tend to interpret case-specific information more aggressively. They obtain similar results in the second experiment, which is set in a more precise standard environment. As the researchers did not include both levels of standard precision in one experiment, they are unable to provide direct evidence on the relative impact that the level of standard precision has on reporting behavior. However, by comparing results from the two experiments, they suggest that aggressive reporting is more likely in rules-based settings. Psaros and Trotman (2004) call for further research designed to more directly compare the relative influence of standards of differing precision on preparers' reporting decisions.

Jamal and Tan (2010) examine whether auditor type (e.g., principles-oriented or rules-oriented) affects financial managers' reporting decisions under rules-based and principles-based standards. They find that auditor type has no effect on reporting decisions under a rules-based standard. However, under a principles-based standard, financial managers are less likely to report aggressively when the auditor is principles-oriented. They speculate that improved financial reporting will result only if a move toward more principles-based standards is accompanied by a shift in auditors' mindsets toward being more principles-oriented. This shift would appear likely to happen relatively quickly because auditors have a responsibility to assure that their clients are in compliance with prevailing standards, regardless of standard type. That is, if there is a move toward principle-based standards such as IFRS, a "rules-based" auditor would quickly have to adjust to an environment in which there are no bright-line thresholds on which to fall back. Thus, the cells from their study that are most relevant for purposes of our study are the two "matched" cells (i.e., principles-oriented auditor/principles-based standard and rules-oriented auditor/rules-based standard). Results from these two cells are not inconsistent with the notion that principles-based standards will typically result in less aggressive financial reporting by preparers.

Standard Precision and Aggressive Financial Reporting

Rules-based standards have developed over time, in part, because of demand for them by financial statement preparers and auditors, who believe that such detailed rules shield them from potential criticism for aggressive reporting (Benston et al. 2006). Aggressive reporting is likely to be more difficult to justify with a less precise standard in which a threshold is not explicitly stated (Maines 2007). The costs associated with being perceived to be out of compliance are similar under both more precise and less precise standards. However, the uncertainty surrounding the risk of being perceived to be out of compliance (i.e., second-guessed) is inherently greater without detailed guidance (Nelson et al. 2002).[6] Thus, preparers applying less precise standards could decide not to select their desired accounting treatment because of the increased risk of second-guessing and the attendant costs. Theoretical research in the areas of law and economics supports the idea that less precise rules could result in less aggressive decisions (Calfee and Craswell 1984; Craswell and Calfee 1986). This outcome could be more likely in the post-SOX era because of

[6] This assumes a strong regulatory enforcement environment (e.g., the post-SOX regulatory environment).

required CEO and CFO certification of the financial statements. Following this reasoning, along with a belief that "objectives-oriented standards allow accounting professionals to operationalize accounting treatments in a manner that best fulfills the objective of each standard and thereby best captures the underlying economic reality," the SEC (2003, 11) and the FASB (2002) have indicated a preference for less precise standards.

There is an implicit assumption underlying this belief that, when the constraints imposed by rules-based standards are removed, financial statement preparers will desire to make accounting choices that best reflect economic reality. However, the FASB (2002, 9) acknowledges that a principles-based approach "could lead to abuse, whereby the principles in accounting standards are not applied in good faith consistent with the intent and spirit of the standards." There are a number of environmental factors that could influence whether a principles-based standard regime leads to more meaningful financial reporting or to abuses of the less-precise guidance. For example, the level of regulatory scrutiny of accounting treatment choices, the degree of consensus among regulators about the appropriate treatment, and the ability of rules-based standards to constrain aggressive choices could influence the efficacy of a principles-based regime.

We choose to examine a setting that best represents the concerns/complaints levied by investors and regulators. Specifically, we examine a rules-based standard that has been unable to constrain aggressive behavior, even in a strong post-SOX regulatory environment in which there is concern about aggressive reporting choices.[7] In such a setting, we expect that the level of standard precision will affect the extent to which financial statement preparers are concerned about second-guessing and possible costs imposed through regulation and litigation. Financial statement preparers should be more concerned about second-guessing when standards are less precise (Nelson et al. 2002). This concern will result in an increased desire to reflect the underlying economics of transactions and events in the financial statements. Presumably, if preparers can show that their accounting choices fairly present economic reality, then they will be better able to defend themselves when second-guessed by external parties (e.g., the SEC). Thus, we argue that less precise standards result in an increased concern about second-guessing and related costs, which in turn results in a greater interest in fair presentation. This reasoning leads to the following hypothesis:

H1: Financial statement preparers applying a less precise financial reporting standard will be less likely to make an aggressive financial reporting decision than preparers applying a more precise standard.

The Influence of the Audit Committee on Aggressive Reporting in Principles-Based and Rules-Based Settings

The audit committee represents a key corporate governance mechanism, in that it is viewed as one of the most important monitors of the financial reporting process (Blue Ribbon Committee 1999). However, a spate of high-profile corporate accounting scandals (e.g., Enron, WorldCom, Tyco) brought the effectiveness of audit committees into question. Regulators and investors have called for stronger audit committees to help ensure higher quality financial reporting. Congress responded by enacting SOX, which, among other things, expands the responsibilities of the audit committee and places a greater focus on its role in enhancing the financial reporting process. Under SOX, the audit committee now is responsible for hiring the company's independent auditor, overseeing the work of the auditor, resolving financial reporting differences between management and the auditor, and monitoring internal controls (Lander 2004). Concurrent with the expansion of

[7] This also represents a setting in which we would be likely to find a benefit of a principles-based approach, should such a benefit exist. For example, if a shift to principles-based standards is accompanied by a reduction in the level of regulatory scrutiny, the potential abuses the FASB (2002) acknowledges are more likely to occur.

the audit committee's role, there has been a push toward greater independence and expertise of audit committee members. SOX now requires all members of the audit committee to be independent (i.e., not currently part of management). Companies must now also disclose whether at least one member of the audit committee is a financial expert. Further, while there are no strict guidelines regarding the frequency of audit committee meetings (the Blue Ribbon Committee [1999] recommends at least four meetings per year), some have called for audit committees to be more active and diligent in carrying out their oversight duties (DeZoort et al. 2002; Stewart and Munro 2007).

Thus, conventional wisdom is that audit committee independence, expertise, and activity can enhance the monitoring and oversight of management, leading to less aggressive financial reporting choices. Prior research appears consistent with this notion (Bédard et al. 2004). Results of archival studies examining U.S.-listed firms suggest that independent members are less likely to be sanctioned for fraudulent or misleading financial reporting, and are negatively associated with abnormal accruals, aggressive earnings management, and earnings restatements (Abbott et al. 2000; Klein 2002; Abbott et al. 2004; Bédard et al. 2004). Similarly, financial expertise on the audit committee is negatively associated with discretionary accruals and aggressive earnings management and is viewed favorably by capital markets (Xie et al. 2003; Abbott et al. 2004; Bédard et al. 2004; DeFond et al. 2005). Further, the frequency of audit committee meetings is negatively related to financial reporting misstatements, earnings management, and perceived audit risk (Abbott et al. 2000; Stewart and Munro 2007). Thus, in the rules-based U.S. reporting environment, a strong audit committee can serve as a monitoring mechanism that helps mitigate aggressive financial reporting behavior.

However, it is less clear whether the same relationship exists, or is as strong, in environments that employ principles-based accounting standards. Assuming a relatively strong regulatory environment, preparers using principles-based standards are likely to perceive greater risk of regulator sanctions due to the inherent uncertainty of the standard. This uncertainty could lead to an increased desire to reflect the economic substance of a transaction, in turn lessening the audit committee's burden to constrain aggressive reporting choices. Many countries using the less precise IFRS either do not require audit committees (e.g., Russia) or they are fairly recent developments (e.g., the European Union) and, as a consequence, are likely weak relative to U.S. audit committees. Thus, there is no direct evidence regarding the relationship between audit committee strength and aggressive reporting in a principles-based setting, and what indirect evidence there is does not lead to clear conclusions regarding the existence or strength of the relationship (Collier and Gregory 1996; Peasnell et al. 2000; Chen and Cheng 2007). However, there are certain settings under which inferences could be drawn regarding the influence of audit committee strength in principles-based standard environments.

Recall that, in our setting,[8] we expect that preparers applying a more principles-based standard will be more concerned about regulator second-guessing and capturing the economic substance of the transaction than preparers applying our rules-based standard, irrespective of the strength of the audit committee (i.e., the H1 expectation). If this is the case, then preparers applying the less precise standard will be more likely than preparers applying the more precise standard to choose the treatment preferred by the audit committee, thereby lessening the burden on the audit committee to curb aggressive reporting. That is, the less precise standard should dampen pursuit of aggressive financial reporting regardless of audit committee strength, reducing the need for the audit committee to exert its influence regarding this reporting choice. We therefore test the following hypothesis:

[8] Our setting is one in which the rules-based standard has been relatively ineffective at curtailing aggressive reporting, even in a strong post-SOX regulatory environment where there is concern about aggressive reporting choices.

H2: The difference in financial reporting judgments made in the presence of a strong audit committee versus a weak audit committee will be greater when a financial reporting standard is more precise than when it is less precise.

III. EXPERIMENT 1

Participants and Design

Participants in experiment 1 are 96 experienced financial statement preparers (55 CFOs, 23 Controllers, and 18 VPs of Finance) with an average of 25.5 years of professional work experience.[9] As our experiment asks participants to assume the role of a company controller faced with a lease classification decision, it was important that we select experienced executives who are likely to play a key role in the financial reporting decisions of their companies.

To test our hypotheses, we conduct an experiment requiring participants to make a lease classification decision in which the two variables of interest (standard precision and audit committee strength) are manipulated at two levels. The *more precise* condition for standard precision includes a bright-line criterion for lease capitalization (lease term is "equal to 75% or more" of expected life) consistent with SFAS No. 13 (FASB 1976). The *less precise* condition includes a vaguer criterion (lease term is "for the major part" of expected life) based on IAS 17 (IASC 1997). In the *strong audit committee* condition, participants are told that all audit committee members are independent with no disclosed relationship with the company and all qualify as financial experts as defined by the SEC, and that the audit committee meets frequently (11 to 12 times per year). For the *weak audit committee* condition, while all committee members qualify as independent, participants are informed that one member has no disclosed prior relationship with the company (two are former officers of the company), one qualifies as a financial expert, and the committee meets infrequently (two to three times per year).[10]

Procedures

We provided participants with a research instrument containing four sections. Section I included guidelines for classifying a lease as either a capital or operating lease. Participants were told only one criterion (relating to the ratio of lease term to estimated economic life) was relevant to the lease classification decision. Specifically, one group of participants was instructed that a lease must be classified as a capital lease if the lease term is "equal to 75% or more" of the

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[9] We mailed instruments to 1,000 individuals identified by the American Institute of Certified Public Accountants (AICPA) as financial executives. We received replies from 106 individuals and 63 were returned as undeliverable. The resulting response rate of 11.31 percent (106 responses divided by 937 delivered) is consistent with prior studies involving CFO/controller participants (e.g., Graham and Harvey 2001; Gibbins et al. 2007; Sanchez et al. 2007). There were ten unusable responses: seven instruments were completed by inappropriately classified individuals such as staff accountants, payroll clerks, and tax accountants (our conclusions remain the same with or without these individuals), and three were returned with no response on the dependent variable. Thus, 96 usable responses remained. Comparisons of early and late responders indicate no significant difference, suggesting that nonresponse bias does not drive our results. With respect to the demographics of our participants (e.g., current or prior experience working at a publicly traded company or as an external auditor, experience with leases), there were no significant differences between conditions and, when included in our analyses, the demographic variables were neither significant nor altered the conclusions we draw.

[10] The features present in both our strong and weak audit committee conditions were selected to represent audit committees that can, and do, exist in today's regulatory environment. For example, our weak committee meets the SOX requirement of independence (no members are currently affiliated with the company) and recommendation for expertise (one member qualifies as a financial expert). With respect to independence, there are numerous publicly traded companies with former employees serving on their audit committees (e.g., FedEx, Goldman Sachs, Kohl's, and Sunoco). Similarly, many firms have a sole designated financial expert (Carcello et al. 2006), including H.J. Heinz Co., CSX Corp., Texas Instruments, Inc., and Nike, Inc. Further, as there are no requirements for frequency of meetings, there is much between-firm variation. Consistent with our weak audit committee manipulation, a number of firms' audit committees meet infrequently (i.e., four or fewer meetings; see Huron 2006).

estimated economic life of the leased property (the more precise standard based on SFAS No. 13). Another group was instructed that a lease must be capitalized if the lease term is "for the major part" of the estimated economic life of the leased property (the less precise standard based on IAS 17). Both groups were told that a lease must be classified as an operating lease if it does not meet the capital lease criterion. In addition, participants were provided the following definitions of "lease term" and "bargain renewal option" based on definitions in both SFAS No. 13 and IAS 17:

- *Lease term* is defined as the fixed non-cancelable term of the lease plus all periods covered by bargain renewal options.
- *Bargain renewal options* allow the lessee to renew the lease for a rental 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.

Given the definition of lease term, lease classification requires financial statement preparers to first judge whether any renewal option embedded in the lease is a bargain. Second, preparers must judge whether the lease term, i.e., the number of years in the fixed non-cancelable portion of the lease plus the number of years in any bargain renewal option, meets the threshold established in the standard.

Section II asked participants to assume the role of controller of a hypothetical company that has entered into a lease for new equipment with an estimated economic life of ten years. The lease has a non-cancelable lease period of seven years. At the end of the initial non-cancelable lease period, the agreement provides the company the option to renew the lease for an additional year, with the monthly rental payment set at a rate that allows for some discretion in judging whether the renewal option represents a bargain.[11] Participants applying the "equal to 75% or more" criterion must exercise their judgment in measuring the "lease term" by determining whether the lease renewal option represents a bargain. They can justify an operating lease classification by arguing that the renewal option does not represent a bargain and therefore the lease term (seven years) is only 70 percent of the asset's economic life (ten years). However, if they judge the renewal option to be a bargain, then they should add the bargain renewal option period (one year) to the initial lease period (seven years) and view the lease term as eight years, which is 80 percent of the asset's economic useful life. In this case, the bright-line threshold in the standard should cause them to classify the lease as a capital lease. Participants applying the less precise standard must exercise similar judgment in determining whether the lease renewal option represents a bargain. However, their interpretation of "for the major part" also factors into their lease classification decisions.[12]

Participants were provided a summary of the differential impact of the two accounting treatments on the company's financial statements and key ratios at the end of the first year of the lease. The summary shows that capitalization of the lease generally produces less favorable financial results, including lower EPS and return on assets figures and a larger debt-to-equity ratio. Thus, participants generally should have an incentive to classify the lease as an operating lease. To make this incentive more salient, participants were told that the company is publicly traded and that it

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[11] Controllers at several *Fortune* 500 companies suggested that setting the renewal option at approximately 90 percent of the fair rental value would be sufficiently ambiguous to require judgment as to whether it represents a bargain (i.e., whether to include it as part of the total lease term). Thus, we set the option at 90 percent to provide an opportunity for the financial incentives of alternative classification to factor into participants' lease classification decisions.

[12] That is, for the renewal option to place a participant applying the less precise standard in a similar professional decision context as those applying the more precise standard, a less precise standard participant must interpret "for the major part" as ≥ 71 and ≤ 80 percent of economic life. We, therefore, conduct an analysis comparing those participants in the 71 to 80 percent range to those in the more precise group (i.e., for both groups of participants, the judgment regarding the option results in a different classification). We discuss this in greater detail below.

intends to raise capital in the second year of the lease term through the issuance of both common stock and the sale of bonds. After considering the case information, participants recorded their lease classification decisions and responded to several post-experimental and demographic questions (Sections III and IV of the instrument).

Experiment 1 Results

Our hypotheses are tested using a 2 × 2 ANOVA (standard precision by audit committee strength) with the financial statement preparer's lease classification decision serving as the dependent variable.[13] Due to the directional nature of expectations, all tests of hypotheses are one-tailed. Cell means and ANOVA results are presented in Table 1.[14]

Standard Precision

H1 predicts that financial statement preparers applying a precise standard will be more likely to make an aggressive financial reporting decision (i.e., classify the lease as an operating lease) than preparers applying an imprecise standard. Preparers recorded their lease classification decisions on a ten-point, forced-choice scale (1 = "Definitely classify as an operating lease" and 10 = "Definitely classify as a capital lease"). Table 1 reports results consistent with expectations. Specifically, preparers are more likely to report aggressively when presented with a more precise standard (mean = 4.98) than with a less precise standard (mean = 7.83, $F = 23.36$, $p < 0.001$).

It is important to establish that these findings are not solely a function of our manipulation of precision resulting in essentially different decision contexts for the less and more precise conditions. That is, for participants in the less precise standard condition, the term "for the major part" is subject to interpretation. For a more meaningful comparison, participants in the less precise condition must be placed in a similar decision context to those in the more precise condition. Specifically, participants' interpretations of "for the major part" must place them in a situation in which their professional judgment regarding the renewal option is meaningful (i.e., the judgment regarding the option results in a different lease classification decision).[15] Of the 47 participants in the less precise group, 19 indicated that they interpreted the phrase within this professional judgment range (i.e., as ≥71 percent and ≤80 percent).[16] As a more restrictive test of the effect of

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[13] As a manipulation check for audit committee strength, participants were asked to assess (on a seven-point scale where 1 = Low and 7 = High) the company's audit committee along three dimensions: independence from management, accounting/financial expertise, and frequency of meetings. t-tests indicate that participants in the strong audit committee condition assessed the committee's independence (mean = 6.29), accounting/financial expertise (mean = 6.41), and frequency of meetings (mean = 6.63) to be significantly higher (all p's < 0.001) than participants in the weak condition (means of 2.93, 2.52, and 2.84 for independence, expertise, and frequency of meetings, respectively), suggesting that our audit committee manipulation was successful. With respect to the standard precision manipulation, 85 percent of participants correctly identified the applicable standard. Our conclusions remain the same if participants who failed this manipulation check are excluded from the analysis.

[14] Levene's test for equality of variances indicates violations of the ANOVA assumption of homogeneity of variances for the lease decision (discussed later). While ANOVA results are typically quite robust to violations of this assumption (Box 1954; Lindman 1974), we also conduct analyses on transformations (i.e., square root, natural log, inverse function, and ranking transformations) of our dependent variable for assurance. Results of these analyses are consistent with the results presented in Table 1.

[15] That is, if a participant in the less precise condition interprets "for the major part" as ≤70 percent, then the fixed term of the lease alone would automatically result in capitalization. If the interpretation is > 80 percent, then the lease would be treated as an operating lease regardless of whether the renewal option is determined to be a bargain. In either case, the participant's professional judgment regarding the renewal option would be irrelevant to the classification of the lease. Thus, we focus this analysis on those participants whose responses were within the range that requires a "professional judgment" similar to that required of participants in the more precise standard condition.

[16] Mean and median responses for the 47 participants in the less precise group are 69.13 and 70 percent, respectively, with 27 participants interpreting "major part" as ≤70 percent, 19 as within the 71 to 80 percent "judgment required" range, and one as > 80 percent.

TABLE 1

Experiment 1: Lease Classification Decisions (Likelihood Scale)

Panel A: Mean (Standard Deviation)[a]

	Audit Committee		
Standard Precision	**Weak**	**Strong**	**Overall**
Less precise	8.14 (2.24) n = 21	7.58 (2.75) n = 26	7.83 (2.52) n = 47
More precise	4.13 (3.08) n = 23	5.73 (3.51) n = 26	4.98 (3.38) n = 49
Overall	6.05 (3.36) n = 44	6.65 (3.25) n = 52	

Panel B: ANOVA Results

	F	**p-value[b]**
Model	8.76	<0.001
Experimental Variables		
Standard Precision	23.36	<0.001
Audit Committee	0.73	0.396
Interaction		
Standard Precision × Audit Committee	3.19	0.039

[a] Participants indicated the likelihood they would classify a lease 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").

[b] Where expectations are directional, p-values are based on one-tailed tests.

standard precision, we retest H1 using only these 19 participants (non-tabulated mean = 7.00 for these individuals). A comparison with responses from the more precise group (mean = 4.98) provides additional support for H1 ($p = 0.013$).[17]

To further explore the effect of standard precision, we dichotomize preparers' responses at the midpoint as a measure of the practical significance of their lease classification decisions. Analysis with the dichotomized variable reveals that participants in the more precise standard condition are significantly more likely to take the aggressive position of classifying the lease as an operating lease than those applying a less precise standard. Sixty-one percent of preparers in the more precise condition classified it as an operating lease versus 15 percent in the less precise condition ($\chi^2 = 21.74$, $p < 0.001$; Table 2), providing further support for H1.

Additionally, in accordance with the development of H1, participants appear to interpret the facts of the lease scenario in a manner consistent with their classification decisions. We find a significant correlation between their classification decisions and their interpretation of whether the

[17] Results are similar when the data are parsed to include only those in the less precise condition who interpret "for the major part" as ≥75 percent (i.e., participants whose interpretations are as high as, or higher than, the threshold in the more precise standard).

TABLE 2

Experiment 1

Contingency Analysis of Lease Classification Decision by Standard Precision Condition

	Lease Classification Decision		
Standard Precision	**Operating Lease**	**Capital Lease**	**Row Total**
Less precise	7	40	47
Row %	14.89%	85.11%	100.00%
More precise	30	19	49
Row %	61.22%	38.78%	100.00%
Column total	37	59	

$\chi^2 = 21.74$ ($p < 0.001$)

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* and responses of 6 to 10 are classified as *Capital Lease*.

option to renew the lease at the end of the lease term represents a bargain (Pearson $r = 0.580$; $p < 0.001$). That is, participants who indicate they are more likely to capitalize the lease tend to believe more strongly that the renewal option represents a bargain.

The Influence of the Audit Committee

H2 predicts that audit committee strength will have a greater effect on aggressive reporting in a rules-based regime (where a strong audit committee could inhibit financial statement preparers' opportunistic application of a standard) than in a more principles-based regime (where greater concern about regulator sanctions could lessen the burden on the audit committee to constrain aggressive reporting). Table 1 reports a significant and directionally consistent interaction between standard precision and audit committee strength ($F = 3.19$, $p = 0.039$), providing support for H2. Further, non-tabulated comparisons within each of the standard precision conditions reveal that audit committee strength influences lease classification decisions under the rules-based regime (means = 5.73 and 4.13 for the strong and weak audit committee conditions, respectively, $p = 0.049$), but not under the principles-based regime (means = 7.58 and 8.14 for the strong and weak audit committee conditions, respectively, $p = 0.441$).

An interesting finding emerges when we compare the mean responses in Table 1 in the more precise standard/strong audit committee condition (mean = 5.73) with those in the two less precise standard conditions (means = 7.58 and 8.14 for the less precise/strong and less precise/weak conditions, with two-tailed p-values of 0.040 and 0.007, respectively). We find that both of the less precise standard conditions lead to less aggressive reporting, regardless of audit committee strength. While it is important to stress the context-specific nature of this result, the shift to a more principles-based standard appears to have a greater dampening effect on aggressive reporting than increasing the strength of the audit committee does in our setting.

Comparability

A concern with moving from more precise (rules-based) to less precise (principles-based) standards is that it could result in reduced financial statement comparability across firms (FASB 2002; Nelson 2003; Schipper 2003; SEC 2003). If this concern has merit, one would expect the variability of lease classification decisions to be greater with a less precise standard than with a more precise standard. Contrary to concerns, Table 1, Panel A reveals that there is *less* variability (as measured by the standard deviation) in the decisions made by preparers in the less precise standard group than in the more precise group (SD = 2.52 and 3.38, respectively). Levene's test for equality of variances indicates a significant difference between the two groups ($F = 15.397$, $p < 0.001$, two-tailed, non-tabulated). This suggests that application of more principles-based standards need not result in less inter-firm comparability than more precise standards.

IV. EXPERIMENT 2

Concern for Sanctions and Economic Substance: A Three-Path Mediating Model

In experiment 1, we find a significant relationship between standard precision and financial statement preparers' lease classification decisions. Specifically, a less precise (more principles-based) standard results in less aggressive financial reporting (H1). The development of H1 suggests two potential mediators of this relationship. With their bright-line thresholds, rules-based standards can invite transaction structuring and incentive-consistent standard interpretation to achieve preferred accounting treatments (FASB 2002; Bockus et al. 2003; Nelson 2003). Thus, as Maines (2007) suggests, financial statement preparers could prefer rules-based standards because they are believed to reduce second-guessing by regulators as to whether a standard has been applied opportunistically. Aggressive reporting could be more difficult with a principles-based standard in which a threshold is not explicitly stated, as the risk of being perceived to be out of compliance is greater due to the inherent uncertainty of the standard (Nelson et al. 2002). When there is uncertainty regarding the proper accounting, preparers might decide not to select their desired treatment because of the increased risk of second-guessing by regulators, as well as the costs accompanying such sanctions (Calfee and Craswell 1984; Craswell and Calfee 1986). This increased concern for second-guessing would result in a greater desire to reflect the underlying economics of transactions and events in the financial statements. That is, if preparers can show that their reporting decisions fairly represent economic reality, they will be better able to defend themselves when second-guessed by regulators. We propose a three-path (two-mediator) model in which concern about second-guessing and interest in reporting the economic substance of a transaction sequentially mediate the relationship between standard precision and aggressive reporting. Experiment 2 is designed to explore this mediating relationship and tests the following hypothesis:

H3: Concern about second-guessing by regulators and the desire to report the economic substance of the transaction will (sequentially) mediate the relationship between standard precision and financial statement preparers' aggressive financial reporting decisions.

Task and Procedure

Similar to experiment 1, participants were 92 experienced financial statement preparers (i.e., CFOs, Controllers, VPs of Finance) with an average of 24.9 years of professional work experience.[18] Experimental materials were similar to those used in experiment 1. Again, we manipulate standard precision and audit committee strength and ask participants to make a lease classification decision. However, we made minor modifications to the details of the lease agreement in an effort to rule out the possibility that a ceiling effect is responsible for our experiment 1 finding that the burden on the audit committee to curb aggressive reporting eases with a move toward a more principles-based standard (i.e., mean responses for participants in both principles-

[18] We conducted another mailing to 1,000 financial executives, receiving 99 replies with 88 returned as undeliverable for a response rate of 10.9 percent. Seven responses were unusable: five were completed by inappropriately classified individuals (our conclusions remain the same with or without these individuals), and two were returned with no response on the dependent variable, resulting in 92 usable responses. Demographic variables (e.g., experience-related measures, years at current job) were not significantly different between conditions and, when included in our analyses, were neither significant nor altered the conclusions we draw.

based conditions were relatively close to the high, or "capitalize," endpoint of the response scale). The modifications to the lease agreement were designed to allow for greater freedom for upward movement on the scale, such that an effect of audit committee strength would be more easily detectible. Specifically, relative to experiment 1, we reduced the fixed non-cancellable term of the lease to five years. The option to renew the lease was increased to three years, but at a rental payment of 92 percent of the equipment's fair rental value. The rental payment was increased to make it easier for participants to conclude that the renewal option is *not* a bargain and thus justify classifying the lease as an operating lease (i.e., to move participants down the response scale to, hopefully, rule out the possibility of a ceiling effect driving our H1 findings for experiment 1). Further, the changes in the length of the fixed term and option increase the proportion of participants in the principles-based standard condition for whom the lease classification requires judgment. These modifications allow for a wider range of participants' interpretations of "for the major part" (i.e., ≥51 percent and ≤80 percent) to place them in a situation in which their professional judgment regarding the renewal option is meaningful (i.e., the judgment regarding the option results in a different lease classification decision).

In an effort to attempt to identify the mechanisms driving our findings in experiment 1 (and test H3), we ask about several factors that could influence participants' lease classification decisions. Participants were asked, post-experimentally in experiment 2, to consider how much their decisions were influenced by five potentially influential factors (relative to other potential factors). These factors relate to their desire to: (1) "Report the economic substance of the lease in the financial statements," (2) "Avoid possible second-guessing of my decision by the company's audit committee," (3) "Avoid possible second-guessing of my decision by the company's auditor," (4) "Avoid possible second-guessing of my decision by external watchdogs such as the Securities and Exchange Commission," and (5) "Present the company's financial position and profitability as favorably as the circumstances will allow."

Experiment 2 Results

The 2 × 2 ANOVA results presented in Table 3 confirm the results of experiment 1. Again, we find a significant main effect of standard precision (H1), with preparers applying a more precise standard reporting more aggressively (mean = 3.41) than those applying a less precise standard (mean = 6.19, $p < 0.001$).[19] Dichotomizing participants' responses, we find that participants in the more precise standard condition are significantly more likely to take the aggressive position of classifying the lease as an operating lease (77.3 percent) than those applying a less precise standard (33.3 percent; $\chi^2 = 17.86$, $p < 0.001$, non-tabulated), consistent with H1. Further, we again report significantly less variability in decisions made by preparers in the less precise standard group than in the more precise group (SD = 1.48 and 2.20, respectively; Levene Statistic = 14.918, $p < 0.001$). This result provides additional evidence that principles-based standards might not reduce inter-firm comparability as some have feared. We again find a significant interaction ($p = 0.012$) between standard precision and audit committee strength (H2). Note also that these results appear to rule out the possibility that a ceiling effect is responsible for our H2 results in experiment 1. That is, although the mean responses in the less precise standard conditions were

[19] All participants in the less precise condition interpreted "for the major part" within the range in which their professional judgment regarding the renewal option is required (i.e., ≥51 percent and ≤80 percent for experiment 2; overall mean and median responses are 68.92 and 70 percent, respectively). Thus, it is unnecessary to conduct the more restrictive test of H1 we utilized for experiment 1. Further, results are similar when the data are parsed to include only those in the less precise condition who interpret "major part" as ≥75 percent (i.e., as high as, or higher than, the threshold in the more precise standard). Eighteen of the 48 participants in the less precise condition fall into this category.

TABLE 3

Experiment 2
Lease Classification Decisions (Likelihood Scale)

Panel A: Mean (Standard Deviation)[a]

	Audit Committee		
Standard Precision	**Weak**	**Strong**	**Overall**
Less precise	6.13 (1.46) n = 23	6.24 (1.54) n = 25	6.19 (1.48) n = 48
More precise	2.50 (1.79) n = 22	4.32 (2.23) n = 22	3.41 (2.20) n = 44
Overall	4.36 (2.44) n = 45	5.34 (2.11) n = 47	

Panel B: ANOVA Results

	F	**p-value[b]**
Model	22.76	<0.001
Experimental Variables		
Standard Precision	56.48	<0.001
Audit Committee	6.81	0.011
Interaction		
Standard Precision × Audit Committee	3.13	0.012

[a] Participants indicated the likelihood they would classify a lease 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").
[b] Where expectations are directional, p-values are based on one-tailed tests.

a considerable distance away from the "capital lease" endpoint of the scale (overall mean of 6.19 on a ten-point scale), our finding that the influence of audit committee strength diminishes with a move toward a more principles-based standard still holds.

Table 4 presents means for the regulator second-guessing and economic substance variables used to test H3, as well as three other potential influencing factors. Participants recorded on 11-point scales (0 = "Little influence relative to other factors" and 10 = "Very strong influence relative to other factors") the extent to which their lease classification decisions were influenced by these factors. Consistent with our arguments leading to H3, we find that participants applying a less precise standard are more concerned with avoiding regulator second-guessing when making their lease classification decision than those applying a more precise standard (means = 6.64 and 2.14, respectively, $p < 0.001$). Participants in the less precise standard condition also are more concerned with reporting the economic substance of the lease in the financial statements than participants in the more precise standard condition (means of 7.17 and 4.30, respectively, $p < 0.001$).

H3 proposes a three-path mediation model in which concern about second-guessing by regulators and desire to report the economic substance of a transaction sequentially mediate the rela-

TABLE 4

Experiment 2
Factors Influencing the Lease Classification Decision

	Less Precise Standard			**More Precise Standard**		
	Weak Audit Committee	**Strong Audit Committee**	**Total**	**Weak Audit Committee**	**Strong Audit Committee**	**Total**
Dependent Variable	**(n = 23)**	**(n = 25)**	**(n = 48)**	**(n = 22)**	**(n = 22)**	**(n = 44)**
Regulator Second-Guessing						
Mean	6.67	6.60	6.64	1.95	2.32	2.14
(Std. Dev.)	(2.15)	(1.94)	(2.01)	(0.99)	(1.17)	(1.09)
Economic Substance						
Mean	7.09	7.24	7.17	3.77	4.82	4.30
(Std. Dev.)	(2.04)	(1.74)	(1.87)	(1.97)	(1.84)	(1.96)
Audit Committee Second-Guessing						
Mean	1.83	3.44	2.67	1.77	6.00	3.89
(Std. Dev.)	(0.94)	(1.45)	(1.46)	(1.02)	(1.95)	(2.63)
Auditor Second-Guessing						
Mean	3.65	3.60	3.63	3.68	3.91	3.80
(Std. Dev.)	(1.23)	(1.19)	(1.20)	(1.32)	(1.27)	(1.29)
Favorable Financial Presentation						
Mean	3.50	3.28	3.39	7.32	6.41	6.86
(Std. Dev.)	(2.38)	(2.73)	(2.56)	(2.32)	(1.92)	(2.15)

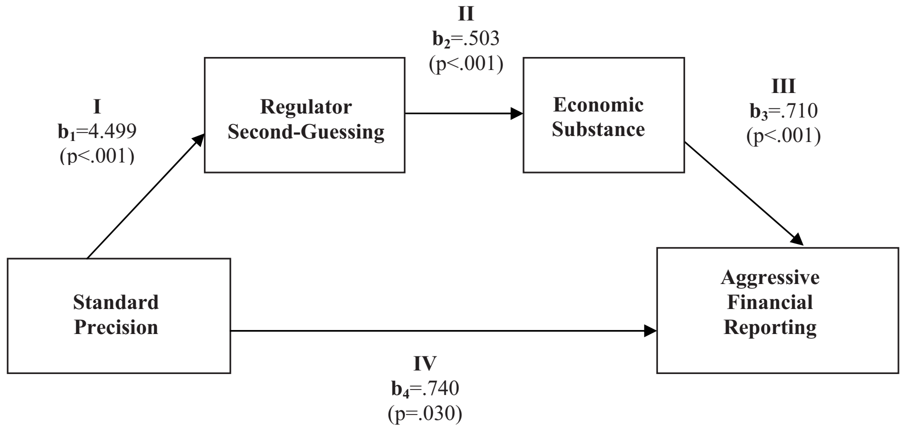
Participants responded to the prompt "Relative to other factors, how much was your lease classification decision influenced by your desire to …" on 11-point scales, where 0 = "Little influence relative to other factors" and 10 = "Very strong influence relative to other factors" for each of the following factors: "Avoid possible second-guessing of my decision by external watchdogs such as the Securities and Exchange Commission" (*Regulator Second-Guessing*); "Report the economic substance of the lease in the financial statements" (*Economic Substance*); "Avoid possible second-guessing of my decision by the company's audit committee" (*Audit Committee Second-Guessing*); "Avoid possible second-guessing of my decision by the company's auditor" (*Auditor Second-Guessing*); and "Present the company's financial position and profitability as favorably as the circumstances will allow" (*Favorable Financial Position*).

tionship between standard precision and aggressive reporting. Figure 1 reports the results of our test of this model, which support H3. The predicted mediating relationship is demonstrated by the following regression results (MacKinnon and Dwyer 1993):

(1) Standard precision significantly affects concern for regulator second-guessing (path I in Figure 1, $b_1 = 4.499$, $p < 0.001$),
(2) Concern for regulator second-guessing influences desire to present the economic substance of the transaction (path II, $b_2 = 0.503$, $p < 0.001$),
(3) Concern for reporting the economic substance of the transaction significantly influences aggressive financial reporting (path III, $b_3 = 0.710$, $p < 0.001$), and
(4) Inclusion of concern for reporting the economic substance of the transaction in the analysis reduces the effect of standard precision on aggressive reporting (path IV, $b_4 = 0.740$ and $p = 0.030$ when concern for economic substance is included in the regression versus $b_4 = 2.778$ and $p < 0.001$ when concern for economic substance is *not* included in the regression).

Further, we find that the mediating effect predicted by H3 is significant ($z = 2.35$, $p = 0.009$; see MacKinnon and Dwyer 1993). Thus, this analysis identifies two mechanisms that help explain the

FIGURE 1
Experiment 2: Three-Path Mediation Model and Results



Standard Precision is the treatment variable manipulated at two levels (0 = more precise; 1 = less precise).
Aggressive Financial Reporting is a participant's lease classification decision recorded on a ten-point scale, where 1 = "Definitely classify as an operating lease" and 10 = "Definitely classify as a capital lease." Lower responses are indicative of more aggressive reporting decisions.
Regulator Second-Guessing is a participant's response to the post-experimental question "Relative to other factors, how much was your lease classification decision influenced by your desire to: Avoid possible second-guessing of my decision by external watchdogs such as the Securities and Exchange Commission" (recorded on an 11-point scale where 0 = "Little influence relative to other factors" and 10 = "Very strong influence relative to other factors").
Economic Substance is a participant's response to the post-experimental question "Relative to other factors, how much was your lease classification decision influenced by your desire to: Report the economic substance of the lease in the financial statements" (recorded on an 11-point scale where 0 = "Little influence relative to other factors" and 10 = "Very strong influence relative to other factors").
b_1 through b_4 are the estimated coefficients from the following regression equations:

$$Regulator\ Second\text{-}Guessing = \beta_{01} + \beta_1(Standard\ Precision) + \varepsilon_1$$

$$Economic\ Substance = \beta_{02} + \beta_2(Regulator\ Second\text{-}Guessing) + \varepsilon_2$$

$$Aggressive\ Financial\ Reporting = \beta_{03} + \beta_3(Economic\ Substance) + \beta_4(Standard\ Precision) + \varepsilon_3$$

To determine the significance of the mediating relationship (paths I through III), a z-score is calculated using the coefficient values and their standard errors. We calculate the variance of the mediating effect (S_{b1b2b3}) using a first-order Taylor series estimate (multivariate delta method) (MacKinnon and Dwyer 1993): $z = (b_1b_2b_3) / S_{b1b2b3} = 2.35$ ($p = .009$).

results we obtained in experiment 1 related to the influence of level of standard precision on aggressive financial reporting (H1).

Other Factors Influencing the Lease Classification Decision

Table 4 presents three other potential influencing factors: concern for second-guessing by the audit committee, concern for second-guessing by the auditor, and desire to present the company's financial position as favorably as the circumstances allow. Consistent with prior archival work in rules-based settings, audit committee strength appears to have significant influence over participants' decisions when applying a more rules-based standard (means of more precise standard/strong audit committee and more precise standard/weak audit committee = 6.00 and 1.77, respectively, $p < 0.001$).

It is interesting to note, however, that a stronger audit committee appears relatively less influential in our more principles-oriented setting (means of less precise standard/strong audit committee condition and more precise standard/strong audit committee condition = 3.44 and 6.00, respectively, $p < 0.001$). This is consistent with our finding that our principles-based standard eases the burden on audit committees (whether strong or weak) to curtail management's aggressive reporting choices.[20] That is, when applying our more principles-oriented standard, it appears that preparers are concerned primarily about regulator second-guessing. This, in turn, dampens pursuit of aggressive financial reporting and results in reporting choices that are more consistent with audit committee preferences.

Further examination of potential influential factors in the two more precise standard cells suggests that, when the audit committee is weaker, financial statement preparers are more concerned with presenting the company's financial position as favorably as the circumstances will allow (mean = 7.32) than when the audit committee is stronger (mean = 6.41, $p = 0.082$). It also is interesting to note that presenting a favorable financial position has a much smaller influence on the lease classification decision for participants in the less precise standard condition than for participants in the more precise standard condition (means of 3.39 and 6.86, respectively, $p < 0.001$).

V. SUMMARY AND CONCLUSIONS

As a result of recent corporate accounting scandals, the U.S. Congress passed SOX in an effort to reform the U.S. financial reporting system. In turn, this legislation has pushed the SEC and the FASB to consider reforms designed to inhibit aggressive financial reporting. These reforms include a shift toward more principles-based accounting standards and enhancing the role of the audit committee. We provide the first evidence on how these two SOX-related regulatory initiatives jointly impact financial statement preparers' reporting judgments. Specifically, our study reports the results of two experiments investigating the effect of financial reporting standard precision on experienced financial statement preparers' financial reporting judgments, as well as the potential role that audit committee strength plays in mitigating aggressive financial reporting.

Consistent with expectations, our results show that financial statement preparers are less likely to report aggressively when applying a less precise financial reporting standard than when applying a more precise standard. We also find a significant interactive effect of audit committee strength and standard precision on preparers' lease classification decisions. We find that audit committee strength affects aggressive reporting in a rules-based regime by inhibiting financial statement preparers' opportunistic application of a standard. In contrast, audit committee strength has no effect in a more principles-based regime where preparers are more concerned about regulator second-guessing and reporting the economic substance of a transaction regardless of audit committee strength. We also find support for a three-path mediating model in which concern about second-guessing by regulators and the desire to report the economic substance of a transaction sequentially mediate the relationship between standard precision and preparers' aggressive financial reporting. Further, we find significantly less variability among preparers' financial reporting

[20] In contrast to the audit committee (a manipulated variable), we did not expect, nor did we find, significant differences between any of the four cells with respect to concern for second-guessing by the auditor ($p = 0.847$).

decisions when a less precise standard is in place. This suggests that, contrary to the concern of some, the application of more principles-based standards need not result in less inter-firm comparability than more precise standards.

Our findings have implications for both practice and research. With respect to practice, our results provide insight into the principles-versus-rules debate and should be of interest to U.S. policy makers as they continue to contemplate a switch from rules-based to principles-based accounting standards. Our findings suggest that moving toward more principles-based standards (such as the SEC's proposed adoption of IFRS) will not necessarily open the door to greater opportunistic reporting by financial statement preparers; instead, this shift could result in more economically meaningful reporting. Also, our results regarding variability in financial statement preparer responses can help allay concerns regarding inter-firm comparability in a principles-based standards regime. Further, in our setting, we find that switching to a more principles-based approach appears to have a greater dampening effect on aggressive reporting than does strengthening the audit committee. This result, while context-specific, warrants further inquiry by policy makers and researchers. Future research could further explore the relationship between audit committee strength and financial reporting quality under more principles-oriented regimes. Finally, prior research suggests that audit partners believe principles-based standards will reduce their power in resolving auditor-client conflicts (Gibbins et al. 2001). However, our results suggest that the number of such disagreements could diminish, which should help alleviate concerns of auditors' lost leverage.

It is important to note that our experiments focus on a setting in which the rules-based standard has been unable to curb aggressive reporting (i.e., the lease capitalization decision), even given a strong regulatory environment in which there is general concern over aggressive reporting choices. To broaden the generalizability of our findings, future research could explore other settings involving more restrictive rules that more effectively bind financial statement preparers to a conservative treatment. Further research could also explore the effect of differing levels of regulatory scrutiny on principles-based standards. Such research would further our understanding of the roles that standard precision and audit committee strength play in mitigating aggressive financial reporting practices.

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