

# **CHAPTER 1**

## **Overview of the Thesis**

## 1.10 INTRODUCTION

This thesis examines how different countries adopt International Financial Reporting Standards (IFRSs). In particular, it examines whether IFRSs are interpreted and applied in a consistent manner within the context of the South Pacific region.<sup>1</sup> It questions the implicit assumption that accounting convergence will automatically lead to comparability in financial reporting (Schultz and Lopez 2001; Rahman et al. 2002; Doupnik and Richter 2004; Doupnik and Riccio 2006). A single set of financial reports will create an open and accountable financial reporting system (Roberts 1991; Lehman 2005) and it is expected that IFRSs will be able to transform complex 'local reality' into universally recognizable and acceptable information (Saravanamuthu 2004, p.296). However, apart from using a single set of standards, comparability in financial reporting also requires consistent interpretation and application of those standards across countries (Doupnik and Richter 2003, p.16). Therefore, achieving comparability in financial reporting is dependent upon two important conditions: (1) IFRSs should be adopted by countries in a similar manner and (2) they should be interpreted and applied in a consistent manner across various countries. The literature on international accounting has denoted these two aspects of comparability in financial reporting as *de jure* (consistency in form or rules i.e. in accounting standards) and *de facto* (consistency in actual application i.e. in accounting practices) accounting.<sup>2</sup>

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<sup>1</sup> The International Accounting Standards Board (IASB) was established in 2001 to replace its predecessor the International Accounting Standards Committee (IASC). The standards formulated by the IASB are referred to as International Financial Reporting Standards (IFRSs), whereas the standards issued by the IASC are known as International Accounting Standards (IASs). Since IASs have been endorsed by the IASB, for the purposes of this thesis, the term IFRSs includes both the IFRSs and IASs (unless where a distinction is necessary).

<sup>2</sup> Chapter 2 elaborates further on these two issues of *de jure* and *de facto* accounting and also provides an overview of studies which have considered each of these aspects.

This study focuses on international accounting literature in the areas of convergence, and accounting judgment and decision making research.<sup>3</sup> Adopting a holistic approach, this thesis considers both the *de jure* and *de facto* aspects of comparability in financial reporting in the South Pacific region. If in adopting IFRSs countries make drastic amendments to IFRSs or if professional accountants across different countries are not able to interpret and apply these standards in a consistent manner, then comparability in financial reporting will not result. Moreover, prior studies have also provided evidence that *de jure* consistency may not necessarily result in *de facto* consistency in the application of accounting standards across countries (see Schultz and Lopez 2001; Rahman et al. 2002). Therefore, it should not be assumed that convergence of accounting standards would automatically lead to comparable accounting practices and financial reports.

The findings of this study will demonstrate the factors that may be acting as constraints in achieving the objectives of accounting convergence, both at the level of adopting accounting standards and at the level of interpreting and applying these standards in a consistent manner.

This chapter is organized as follows. Section two presents the background of the thesis. Section three outlines the aim and objectives of the thesis, followed by an overview of all the four research projects undertaken in this study. Section four broadly describes the contributions of this thesis. The final section provides an overview of how the rest of the thesis is organized.

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<sup>3</sup> Wallace and Meek (2002, p.2) define the domain of international accounting research as being concerned with: (1) "accounting phenomena in one country with lessons or repercussions extending to other countries," (2) "accounting phenomena related to multinational enterprises," (3) "global movements to shape the direction of accounting," and (4) "comparative accounting requirements and practices." A comprehensive review of the accounting judgment and decision making research published during 1971–2005 in the five top-tier accounting journals is reported in Chapter 3.

## 1.20 BACKGROUND

International bodies such as the European Union (EU), the International Organization of Securities Commissions (IOSCO), the Association of South-East Asian Nations (ASEAN) and the World Trade Organization (WTO) are actively working towards the creation of business structures which will facilitate international trade and commerce.<sup>4</sup> Certain aspects of international business and trade—such as law, marketing, finance and economics—have all, by methods such as treaties and bi-lateral agreements, transcended national boundaries and converged (Carlson 1997, p.357). There is an expectation within the international capital market that since accounting is an important source of business information, it should further transcend national boundaries, and practices should also converge (Purvis et al. 1991; Carlson 1997; Whittington 2005). In the international accounting literature, this process has been denoted as ‘harmonization’ or ‘convergence.’

It is important to distinguish between accounting ‘harmonization’ and accounting ‘convergence.’ Nobes (1995) described accounting harmonization as “a process of increasing the compatibility of accounting practices by setting bounds to their degree of variation” (p.117). It is a process of moving from dissimilarity in accounting practices towards a greater uniformity (Tay and Parker 1990). Therefore, harmonization is a process that involves the coordination of divergent accounting standards and policies that are the basis for financial reporting in different countries.

The accounting profession has long ago recognized the need for a harmonized accountancy framework (Harding 1999). The initiative was taken by the profession to create the International Accounting Standards Committee (IASC), which is now known

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<sup>4</sup> There are many other prominent regulatory bodies advocating international convergence of accounting standards such as the World Bank, the International Monetary Fund, the Asia-Pacific Economic Cooperation, the Organization for Economic Co-operation and Development, the International Federation of Stock Exchanges, the International Federation of Accountants and the United States Securities and Exchange Commission (US SEC).

as the International Accounting Standards Board (IASB).<sup>5</sup> This body was established, together with the International Federation of Accountants (IFAC), to promote worldwide improvement and harmonization of accounting and auditing standards. The key role of the IASC was to establish a uniform set of accounting standards for financial reporting, which was done by developing and promulgating the International Accounting Standards. The change of name of the IASC in 2001 to IASB was accompanied by changes in its objectives and structure—the focus has shifted from accounting harmonization to accounting convergence. For example, currently one of the objectives of the IASB is “to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions” (<http://www.iasb.org>). The concept of convergence is defined by Whittington (2005, p.133) as follows:

Convergence means reducing international differences in accounting standards by selecting the best practice currently available, or, if none is available, by developing new standards in partnership with national standard setters. The convergence process applies to all national regimes and is intended to lead to the adoption of the best practice currently available.

The IASB is working with national accounting standard setters to achieve convergence in accounting standards around the world. In order to facilitate this transition, the IASB is providing a platform of high quality standards to enable countries to make a smooth transition from national standards to IFRSs. A survey by Deloitte Touche Tohmatsu (2007) reported that almost hundred countries have adopted or intend to adopt the IFRSs for all their domestic listed companies. For example, countries such as Australia, New

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<sup>5</sup> The move towards greater harmonization of local accounting practices has been traced back to 1904, when the First International Accounting Congress was held in St. Louis, Missouri. Since then subsequent congresses were held at approximately five-yearly intervals. However, it was not until the 1950s that the harmonization issue was brought into the limelight. The respective accountancy bodies lobbying for global harmonization exchanged information on their countries’ accounting practices, with a view to decreasing the diversity of accounting practices. In 1972, the proposal was accepted and accountants fostered plans to establish an organization to develop accounting standards for worldwide acceptance. On 2 July 1973, the accounting profession achieved its aim and formulated a body known as the International Accounting Standards Committee.

Zealand and member states of the European Union (EU) have all adopted the IFRSs.<sup>6</sup> The Norwalk Agreement finalized in September 2002 is also an important step in convergence between the two most powerful accounting institutions, namely the IASB and the US Financial Accounting Standards Board (FASB).<sup>7</sup> The convergence process between the IASB and the FASB took a step further in November 2007 as the US Securities and Exchange Commission (SEC) announced that it will allow non-US companies to file financial results according to IFRSs (IASB 2007). Therefore, convergence of accounting standards around the world has heralded a new era in global standard setting. Accounting convergence has become an essential, albeit implicit, component of the globalization process.

A number of studies which compared accounting standards across nations or with the IFRSs have found increasing similarities between IFRSs and accounting standards in both developed and developing nations over the last few decades (for example, Nair and Frank 1980; Street and Gray 1999; Chamisa 2000; Ampofo and Sellani 2005; Tyrrall et al. 2007). However, some studies have also shown that important accounting differences remain across countries and the scale of international differences in corporate financial reporting is still very large (for example, Choi et al. 2002; Land and Lang 2002; Nobes and Parker 2004). This is because a number of studies have identified country-specific characteristics (such as cultural, institutional and other environmental differences) as being the primary explanatory factors for differences in accounting practices across various jurisdictions (see Rahman et al. 2002 and Baker and Barbu 2007 for a review of these studies). To enhance comparability in financial reporting, additional insight is

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<sup>6</sup> It should be noted that there are differences in the ways in which IFRSs have been adopted by these countries. Whilst the EU has adopted IFRSs, this has been limited to European companies listed on stock exchanges within the EU that prepare consolidated financial statements. On the other hand, Australia and New Zealand have adopted IFRSs for all their reporting entities.

<sup>7</sup> The IASB and FASB are to meet on a regular basis to decide whether major differences in the areas of impairment, income tax, and research and development should be eliminated through one or more short-term standard-setting projects and, if so, to complete or substantially complete work in those areas by 2008. It is also expected that 'significant progress' will be made on other joint projects by 2009, including business combinations, consolidations, fair value measurement requirements, liabilities and equity distinctions, post-retirement benefits, revenue recognition, and the joint conceptual framework (IASB 2006).

needed to identify the causes of differences in accounting convergence among countries. An understanding of the impact of cultural, institutional and other environmental factors of individual countries on accounting convergence will be important for international regulators engaged in this process.

IFRSs contain broad principles and ‘uncertainty expressions’ whose function is to guide judgments made in practice. For example, uncertainty expressions (such as ‘probable,’ ‘significant influence,’ ‘control’ and ‘substantial’) are often used to denote levels of probability in prescribing recognition, measurement, and disclosure of events and transactions in financial reports (Laswad and Mak 1997, p.16).<sup>8</sup> The application of accounting standards which include uncertainty expressions as recognition or disclosure thresholds involves considerable judgment (Doupnik and Riccio 2006, p.254). Inconsistent judgments can have a major impact on a firm’s externally reported accounting numbers and decision making process of the users (Hronsky and Houghton 2001, p.123). Yet, in accounting literature there is limited research on the level of ambiguity in interpretations of such uncertainty expressions or the factors that could potentially influence this ambiguity (see Chapter 3). An understanding of the similarities and differences in interpretation of these uncertainty expressions and judgments of professional accountants across nations should facilitate the move towards convergence of accounting practices, thereby improving the quality and comparability of international accounting information, systems and procedures.

The most obvious researchable issue which emerges from the background presented above is to consider whether convergence of accounting standards will lead to comparable financial reports. A number of researchers including Schultz and Lopez (2001), Rahman et al. (2002), Doupnik and Richter (2004) and Doupnik and Riccio (2006) have called for more research on this issue.

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<sup>8</sup> Chapters 4 and 5 provide further details on ‘uncertainty expressions’ used in IFRSs.

### **1.30 AIM AND OBJECTIVES**

The aim of this study is to empirically examine the implication of the trend towards international convergence of financial reporting standards, particularly where countries differ significantly in terms of culture, size, structure of the underlying economies, and the related experience of accountants in exercising professional judgments. To address this issue, this study has the following objectives:

- To discuss the accounting environment in the South Pacific region and examine whether countries adopt and enforce IFRSs in a similar manner in the region.
- To evaluate the characteristics and significance of prior accounting judgment and decision making studies.
- To examine whether there are differences in judgments of professional accountants within a country when interpreting and applying IFRSs.
- To examine the extent and the cause of differences in judgments between professional accountants across countries when interpreting and applying IFRSs.

Four research projects were undertaken to achieve the above objectives of the study. They are described in detail below.

### **1.31 Paper 1: International Convergence of Financial Reporting Standards: Evidence from the South Pacific Region**

This is an exploratory study which investigates whether countries adopt and enforce IFRSs in a similar manner in the South Pacific region. Specifically, using selected countries from the South Pacific region, this paper investigates the relationship between country-specific characteristics and the selection of the appropriate approach used for the adoption of IFRSs.



The paper first establishes a framework whereby broadly five different approaches for convergence and harmonization of accounting standards are identified. This paper then evaluates each of the approaches used by the countries in the South Pacific region and investigates the relationship between country-specific characteristics and the selection of the appropriate approach.

This study addresses the first objective of the thesis by providing evidence of the ways in which IFRSs are adopted by the countries in the South Pacific region. It is expected that providing a detailed analysis of the factors that contribute to the adoption of a particular approach of convergence will have important policy implications for other countries and regions that may be planning to adopt IFRSs in the near future. The findings of this study may assist national standard setters to identify the approach for the adoption of the IFRSs which may be most suitable to their context.

A version of this paper has been accepted for publication in the forthcoming issue of the *Advances in Accounting, Incorporating Advances in International Accounting* journal.

### **1.32 Paper 2: Accounting Judgment and Decision Making Research: Evaluation of Publications in Top-Tier Accounting Journals (1971–2005)**

This study evaluated the accounting judgment and decision making research published during 1971–2005 in the five top-tier accounting journals. A content analysis is undertaken on the relevant papers published in *Accounting, Organizations and Society* (AOS), *Contemporary Accounting Research* (CAR), *Journal of Accounting & Economics* (JAE), *Journal of Accounting Research* (JAR), and *The Accounting Review* (AR) during this period.

This study addresses the second objective of the thesis. It adds to the extant literature on accounting judgment and decision making by evaluating the characteristics and significance of the papers published in the five top-tier accounting journals and by suggesting avenues for future research. It also reviews and evaluates the theoretical and

methodological strengths and weaknesses of these studies. It is expected that the limitations identified in this review will be useful to improve the research method, theory development and hypotheses formulation stages of future studies. The analysis of this study may also provide the necessary impetus to strengthen the accounting judgment and decision making research in the future. In addition, the evaluation of prior accounting judgment and decision making research has been useful in designing and conducting the following two empirical research projects in this thesis (Papers 3 and 4).

This paper was presented at the *2008 Annual Congress of the European Accounting Association* (Rotterdam, 23–25 April).

### **1.33 Paper 3: Judgments Based on Interpretation of ‘New’ and ‘Complex’ International Financial Reporting Standards within a Country: Evidence from Fiji**

This study extends prior research on accounting judgment and decision making research by examining the effects of ‘new’ and ‘complex’ accounting standards on judgments of professional accountants. It examines whether there are differences in judgments between the big 4 and non-big 4 professional accountants in Fiji when interpreting and applying selected IFRSs. Specifically, it formulates and tests the following hypotheses:

H1: There will be no differences in judgments between big 4 and non-big 4 professional accountants when provided with ‘old’ accounting standards that require simple and less complex judgments.

H2: There will be no differences in judgments between big 4 and non-big 4 professional accountants when provided with ‘new’ accounting standards that require simple and less complex judgments.

H3: There will be differences in judgments between big 4 and non-big 4 professional accountants when provided with 'old' accounting standards that require complex judgments.

H4: There will be differences in judgments between big 4 and non-big 4 professional accountants when provided with 'new' accounting standards that require complex judgments.

H5: Familiarity with accounting standards and complexity in accounting standards will interact to influence the judgments of big 4 and non-big 4 professional accountants. The interaction will have the following effects:

- a) The difference in judgments between big 4 and non-big 4 professional accountants will be greater if standards are 'new' (unfamiliar) when compared to standards that are 'old' (familiar).
- b) The difference in judgments between big 4 and non-big 4 professional accountants will be greater if standards are 'complex' when compared to standards that are less complex.

Data to test the hypotheses were collected using a survey questionnaire administered on professional accountants from both the big 4 and non-big 4 accounting firms in Fiji. The survey was conducted as part of the professional development training program of the Fiji Institute of Accountants in 2004. A total of 135 participants took part in the survey, wherein 60 respondents were from the big 4 accounting firms and 75 respondents were from the non-big 4 accounting firms. The results obtained were then statistically analyzed where differences in judgments between the big 4 and non-big 4 professional accountants were shown using between-subjects univariate analysis of variance (SPSS Univariate Analysis).

This study addresses the third objective of the thesis by providing evidence of whether IFRSs are interpreted and applied in a consistent manner within a country. This research is important because a significant within-country difference in judgments of professional accountants has serious implications for the convergence of accounting standards. The results of this study may be of interest to other countries at a time when IFRSs are increasingly being adopted throughout the world and standard setters are struggling to promote compliance with those standards.

An earlier version of this paper had been presented at the *2005 Emerging Issues in Accounting, Business and Technologies Conference* (Niagara Falls, New York, 4–6 August) where it won the *Segun Wallace Best Paper Award*. A revised version of this paper was also presented at the *American Accounting Association 2007 Annual Meeting* (Chicago, 5–8 August).

#### **1.34 Paper 4: Cultural and Non-Cultural Factors Affecting Judgments of Professional Accountants: A Comparative Study of Australia and Fiji**

This study extends prior cross-cultural research by examining the effects of both cultural and non-cultural variables on the judgments of professional accountants. It examines the extent and the cause of differences in judgments between professional accountants in Australia and Fiji when interpreting and applying selected IFRSs which contain uncertainty expressions. It is expected that the level of conservatism shared by accountants in a country will affect their interpretation of uncertainty expressions used to establish the threshold for recognition of various accounting elements. Specifically, it formulates and tests the following hypotheses:

H1: Fijian and Australian professional accountants will interpret and apply uncertainty expressions in IFRSs differently.

H1a: Fijian accountants will assign a higher numerical probability than Australian accountants to uncertainty expressions that determine the threshold for recognition of assets and increases in net income.

H1b: Fijian accountants will assign a lower numerical probability than Australian accountants to uncertainty expressions that determine the threshold for recognition of liabilities and decreases in net income.

H2: There will be differences in judgments between Australian and Fijian accountants when provided with accounting standards that require the exercise of professional judgments.

H3: The professional accountants in big 4 firms in Australia and Fiji interpret and apply accounting standards that require the exercise of professional judgments differently from those in non-big 4 firms.

H4: National culture and organizational culture will interact to influence the judgments of big 4 and non-big 4 professional accountants in Australia and Fiji. The interaction will have the following effects:

- a) The effect of national culture will be stronger than the effect of organizational culture in influencing the judgments of non-big 4 professional accountants, leading to a greater difference in judgments between non-big 4 professional accountants in Australia and Fiji.
- b) The effect of organizational culture will be stronger than the effect of national culture in influencing the judgments of big 4 professional accountants, leading to a lower level of difference in judgments between big 4 professional accountants in Australia and Fiji.

Data to test the hypotheses were collected using a survey questionnaire administered on professional accountants from both the big 4 and non-big 4 accounting firms in Fiji and

Australia in 2007. In Fiji, the survey was conducted as part of the professional development training program of the Fiji Institute of Accountants where a total of 232 participants took part. In Australia, the survey was distributed in both the big 4 and non-big 4 accounting firms in Sydney and a total of 139 participants took part. The results obtained were then statistically analyzed (primarily using SPSS Multivariate and Univariate analysis) to determine the factors causing differences in the judgments of Australian and Fijian professional accountants.

This study addresses the last objective of the thesis by providing evidence of whether IFRSs are interpreted and applied in a consistent manner across the two countries. In particular, the results assist in understanding the factors causing differences in the judgments of professional accountants when interpreting and applying a set of accounting standards across countries.

This paper has been accepted for presentation at the *2008 Accounting & Finance Association of Australia and New Zealand Conference* (Sydney, 5–8 July).

#### **1.40 CONTRIBUTIONS OF THE THESIS**

This thesis contributes both to the international accounting literature in the areas of convergence, and accounting judgment and decision making in a number of ways. Primarily, it provides evidence of how countries adopt IFRSs and whether IFRSs are interpreted and applied in a consistent manner both within and across countries.

The first paper provides evidence that significant differences exist in the ways in which the IFRSs are adopted and enforced in the South Pacific region. The results suggest that complete comparability in financial reporting may be difficult to achieve across all countries in the South Pacific region even after adopting the IFRSs because of differences in country-specific factors. Significantly, it demonstrates the need for an

improved understanding of the convergence process and the factors that influence financial reporting across countries. An important implication is that the 'ideal convergence situation' might well be undesirable since it would require convergence of other country-specific attributes, which differ significantly across nations.

Although there have been several audit monographs and reviews in the area of audit judgment (for example, Libby 1981; Ashton 1982 & 1983; Ashton and Ashton 1995; Bell and Wright 1995; Trotman 1996; Solomon and Trotman 2003), no such comprehensive review has been published so far for the research undertaken in the domain of accounting judgment. The second paper fills this identified gap in the literature. An important contribution of this paper is that it provides some useful guidance for future accounting judgment and decision making research. In particular, the review shows that there are limited cross-cultural studies undertaken to examine the factors affecting judgments of professional accountants while interpreting and applying accounting standards. An understanding of the factors causing differences in judgments of professional accountants across nations could facilitate this move towards convergence of accounting practices.

The third paper has broadened the scope of prior accounting judgment and decision making research and provides important insights for understanding accounting convergence. Prior studies have generally ignored the impact of a 'new' and 'complex' set of accounting standards on the judgments of professional accountants. In particular, the results of this study show that there are significant differences in the judgments of the big 4 and non-big 4 professional accountants in Fiji when provided with 'new' accounting standards that require 'complex' judgments. An important implication of the result is that it would be premature for the IASB and standard setters of countries adopting the IFRSs to assume that adopting IFRSs will lead to comparable financial reporting across countries. The results of this study clearly imply that consistency in judgment of professional accountants is difficult to attain even within a country, making it an important factor to consider in the convergence process.

The fourth paper adds a new dimension and context to the accounting judgment and decision making literature by examining professional accountants' judgments that are specifically grounded in IFRSs, and importantly, in the context of both a developed country (Australia) and a developing country (Fiji). This study also considers the impact of both the cultural and non-cultural factors that influence the judgments of professional accountants, something which no prior study has examined. Generally, prior studies have looked at these variables independently in a piecemeal fashion and have failed to identify the collective or interactive impact of these on judgments of professional accountants. This study provides evidence that both cultural and non-cultural factors affect how professional accountants interpret and apply accounting standards which contain uncertainty expressions. The results of this study provide important insight into the factors affecting judgments of professional accountants and raise interesting theoretical issues. Particularly, it attempts to advance accounting theory by arguing that national and organizational cultural differences can cause cross-country differences in accounting practices.

Finally, this thesis has several potential policy implications for the IASB, national accounting regulators, professional accountants and educators. These are discussed at the end of each paper and are also briefly outlined in the last chapter of the thesis under 'Overall Conclusions and Further Implications.'

## **1.50 ORGANIZATION OF THE THESIS**

The thesis is organized into six chapters. Chapters 2 to 5 comprise the four self-contained papers. The relevant tables and figures for each paper are provided at the end of the respective papers. However, the references used throughout the various chapters are collated at the end of the thesis. The survey questionnaires that were used to collect the relevant data for studies in Chapter 4 and 5 are also attached in the appendix at the end of the thesis. Chapter 6 is the concluding chapter which summarizes the findings of



each of the four studies and draws appropriate conclusions and implications. The limitations and suggestions for future research are also discussed in Chapter 6.

The details of the six chapters are as follows:

Chapter 1	Overview of the Thesis
Chapter 2	Paper 1: International Convergence of Financial Reporting Standards: Evidence from the South Pacific Region
Chapter 3	Paper 2: Accounting Judgment and Decision Making Research: Evaluation of Publications in Top-Tier Accounting Journals (1971–2005)
Chapter 4	Paper 3: Judgments Based on Interpretation of ‘New’ and ‘Complex’ International Financial Reporting Standards within a Country: Evidence from Fiji
Chapter 5	Paper 4: Cultural and Non-Cultural Factors Affecting Judgments of Professional Accountants: A Comparative Study of Australia and Fiji
Chapter 6	Concluding Remarks

## **CHAPTER 2**

**(Paper 1)**

**International Convergence of Financial Reporting Standards: Evidence  
from the South Pacific Region**

## **ABSTRACT**

Over the last few years there has been a significant increase in the acceptance of International Financial Reporting Standards (IFRSs) which are issued by the International Accounting Standards Board (IASB). Although numerous countries are adopting IFRSs, the approaches used for convergence continue to differ significantly across countries. Using selected countries from the South Pacific region, this paper investigates the relationship between country-specific characteristics and the selection of the appropriate approach for the adoption of IFRSs. The country-specific attributes that have been found to influence convergence are (1) the set of accounting standards that was prevailing in the country at the time when the selection was made, (2) the availability and experience of professional accountants, (3) the relevant education and professional training, (4) the presence of the Big 4 accounting firms, and (5) the accounting regulatory framework. The results of this study suggest that complete comparability in financial reporting may be difficult to achieve across all countries in the region even after adopting the IFRSs because of differences in country-specific factors. These findings are important because they indicate that attention should be concentrated on theorizing and empirically testing the effects of the country-specific attributes on convergence efforts across various jurisdictions.

### **Key words:**

International Financial Reporting Standards

South Pacific region

Convergence

Adoption

Changes

## 2.10 INTRODUCTION

Over the last few years there has been a significant increase in the acceptance of International Financial Reporting Standards (IFRSs) which are issued by the International Accounting Standards Board (IASB). The forces of globalization and political expediency are forcing an increasing number of countries to adopt IFRSs, resulting in an optimistic future for international convergence towards IFRSs. Various approaches to converge or harmonize include adoption of IFRSs in their entirety, full adoption of IFRSs with time lags, selective adoption of IFRSs and countries developing national standards based on IFRSs (Wong 2004, p.7).<sup>1</sup> Additionally, there is considerable variation in the enforcement of accounting standards across jurisdictions internationally (Devi 2003; Hope 2003; Saravanamuthu 2004; Ampofo and Sellani 2005). Adopting the IFRSs is a necessary step towards achieving greater comparability in financial reporting, but needs to be accompanied by an active involvement of all the stakeholders in enforcing these standards (Ball 2001; Casabona and Shoaf 2002; Chen et al. 2002; Ball et al. 2003). The differences in both the adoption of IFRSs and their enforcement is of concern to national and international accounting standard setters, regulators, auditors and financial statement users (Hope 2003, p.265). To enhance comparability in financial reporting, additional insight is needed into the causes of differences in convergence among countries.

A number of studies have shown that convergence and harmonization have contributed to greater comparability in financial reporting in both developed and developing economies (for example, Samuels and Oliga 1982; Doupnik 1987; Brunovs and Kirsch 1991; Peasnell 1993; Zarzeski 1996; EI-Gazzar et al. 1999; Street and Gray 1999; Collett et al. 2001; and Bowrin 2007). In contrast, other researchers have viewed convergence and harmonization as more apparent than real, and have shown that significant differences remain in corporate financial reporting across countries (see Choi

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<sup>1</sup> The distinction between accounting harmonization and accounting convergence has already been noted in Chapter 1.

et al. 2002; Dahawy et al. 2002; Land and Lang 2002; Nobes and Parker 2004; Perera and Baydoun 2007). Saudagaran (2004) also argues that international accounting studies focusing on comparing standards should not assume that harmonized accounting standards would lead to harmonized accounting practices and comparable financial reports. Some countries adopt IFRSs to gain 'instant respectability' or to serve as a 'politically correct substitute' for their own accounting standards (Ball et al. 2003, p.260) without providing reporting incentives and employing mechanisms to enable compliance with these standards. Other countries identify the approach most suitable to their environment in adopting the IFRSs. For example, a number of countries in the South Pacific region (Australia, New Zealand, Fiji and Papua New Guinea) have used different approaches in adopting the IFRSs.

Australia, the largest country of the South Pacific region, has adopted IFRSs with amendments and additions from January 2005. New Zealand has used a similar approach in adopting the IFRSs from 2007, though larger entities were strongly encouraged to adopt IFRSs from 2005. Additionally, like the two more established standard setting bodies in the South Pacific region, the Papua New Guinea Accounting Standards Board (PNGASB) has adopted IFRSs in their entirety since 2000, and Fiji has adopted IFRSs selectively since 2002. Other regional countries in the South Pacific (notably Kiribati, Marshall Islands, Micronesia, Nauru, Palau, Solomon Islands, Tonga, Tuvalu, Vanuatu and Samoa), having neither well-established accounting bodies nor standard setting bodies, are still adhering to their older systems under which multinational enterprises adopt the accounting practices used by parent companies overseas and local business enterprises use the accounting practices of the colonizers, amongst which the UK, Australia, New Zealand, the US and France are the principal ones. For example, the Marshall Islands, being a US trust territory since 1945, follows US accounting practices. These differences among the countries in the South Pacific region provide a unique environment to identify the relationship between country-specific characteristics and the choice of an appropriate approach for the adoption of IFRSs. The selected indicators depicting the similarities and differences between the four major countries in the South

Pacific region (Australia, New Zealand, Fiji and Papua New Guinea) are summarized in table 2.1.

<Insert Table 2.1 here>

Studies that have examined harmonization and convergence suggest that country-specific attributes influence financial reporting practices in a country. The country-specific attributes found to have an impact include professional and independent auditors, an independent standard setting body, and an effective and independent regulatory enforcement body. A number of studies have shown that financial reporting systems adopted by countries are influenced by the local environment and tend to reflect the professional and institutional pressures and influences (Perera 1989; Zarzeski 1996; Archambault and Archambault 1999; Hopwood 2000; Collett et al. 2001; Pope 2003). However, there is a lack of evidence as to why countries are adopting different approaches in convergence. Primarily, studies have examined the relationship between convergence and various aspects of capital markets (see Graham and Neu 2003 for a review of these studies). However, limited research has been conducted to understand the role of other country-specific factors and institutions that influence the diffusion of common practices outside of capital markets (Graham and Neu 2003, p.450). Therefore, in a world with significant institutional and other environmental differences between countries, an understanding of these links is potentially important for international regulators engaged in the drive towards convergence of accounting standards (Pope 2003, p.273).

The present study investigates various factors that are driving countries to adopt particular approaches in convergence. In particular, by using selected countries from the South Pacific region, this paper investigates the relationship between country-specific characteristics and the selection of the appropriate approach used for the adoption of IFRSs. In this study the country-specific attributes that are found to influence convergence are (1) the set of accounting standards that was prevailing in the country at

the time when the selection was made, (2) the availability and experience of professional accountants, (3) the relevant education and professional training, (4) the presence of the Big 4 accounting firms, and (5) the accounting regulatory framework which includes the system of developing, enforcing and monitoring compliance with accounting standards.

The results of this study suggests that complete commonality and uniformity in accounting standards may not occur even after adopting the IFRSs as countries may make amendments to IFRSs to suit their local contexts. The present study also identifies various approaches used in adopting IFRSs which may be useful for countries in identifying the approach most suitable for successful convergence. The 'ideal convergence situation' is utopian and might well be undesirable (Garrido et al. 2002, p.15) since it would require the convergence of country-specific attributes, which differ significantly across nations. Because of their importance, attention should be concentrated on theorizing and empirically testing the influence of the country-specific attributes on convergence efforts across various jurisdictions.

The remainder of the paper is organized as follows. The first section provides an overview of country-specific factors influencing convergence and outlines a framework for convergence and harmonization. The second section analyzes each of the selected countries in the South Pacific region and identifies various factors that may be considered by countries that intend to adopt the IFRSs. Finally, the paper offers implications and conclusions on how countries can achieve convergence and harmonization compatible with their country-specific characteristics.

## **2.20 COUNTRY-SPECIFIC ATTRIBUTES INFLUENCING CONVERGENCE AND FRAMEWORK FOR CONVERGENCE AND HARMONIZATION**

### **2.21 Country-Specific Attributes Influencing Convergence**

The analysis of standard setting must not be restricted to key stakeholders in isolation. Instead some understanding of the domestic and global economy is necessary. As accounting is seen to affect economic development, accounting itself is also affected by local and global environmental factors (Larson 1993). For example, Devi (1999) presented a model which showed that an analysis of standard setting must not be restricted to key participants in the standard setting process in isolation. Instead an overall understanding of the domestic political economy and the global political economy is pertinent.

Mueller (1967) pioneered the idea that country-specific attributes such as culture, economic, social and legal systems should be considered in the formulation and promulgation of accounting standards. Since then much attention has been given in international comparative accounting literature to cluster accounting systems of various countries based on similar financial reporting characteristics. A number of studies have developed models to identify factors that may explain differences in financial reporting and to show areas of similarities between countries (Mueller 1968; American Accounting Association 1977; Nair and Frank 1980; Nobes 1983 & 1998; Gray 1988; Douppnik and Salter 1995; Nobes and Parker 2004). For example, studies such as Mueller (1968), Mueller et al. (1994), and Nobes and Parker (2004) have clustered nations with similar patterns of accounting development based on ‘zones of influence’ criteria.<sup>2</sup>

The international comparative studies have classified countries according to accounting regulations and practices to provide macro characteristics that differentiate country

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<sup>2</sup> The American Accounting Association (1977) provided the following classification of five zones of influence: British, Franco-Spanish-Portuguese, German/Dutch, United States and Communistic. A more recent classification by Mueller et al. (1994) has four zones of influence: British-American, Continental, South American and Mixed economy.



clusters (see Rahman et al. 2002 for reviews of these studies). Research into the development of individual national accounting systems has shown this to be largely a function of environmental factors such as economic and legal systems, culture, educational background and the impact of training on individual accountants (Gray 1988; Perera 1989; Doupnik and Salter 1995; Zarzeski 1996; Jaggi and Low 2000). Additionally, environmental factors (such as economic, educational and political), institutional structures (such as corporations and stock markets), and decision-makers (such as investors and lenders) differ across nations and contribute to the type and amount of accounting information provided in a particular country (Schweikart 1985; Nobes 1998). However, the relationship between the hypothesized reasons and the level of convergence that actually exists between countries is not clear and the nature of the impact of these on accounting is yet to be empirically tested (Rahman et al. 2002, p.48).

In the harmonization literature, van der Tas (1988) and Tay and Parker (1990) identified two different forms of harmonization, which they term *de jure* and *de facto* accounting. Recall (from Chapter 1) that *de jure* accounting represents harmonization of accounting standards and *de facto* accounting represents the harmonization of accounting practices.<sup>3</sup> This distinction is important because harmonization of national standards across countries is one of the major factors affecting the international harmonization of practices (Archer et al. 1995, p.80). A number of studies have assessed the *de jure* accounting aspect of harmonization (for example, Nair and Frank 1980; Street and Gray 1999; Chamisa 2000; Ampofo and Sellani 2005). By comparing accounting standards across nations or with the IFRSs, these studies find increasing similarities between IFRSs and accounting standards in both developed and developing nations. Moreover, a number of studies have examined various aspects of *de facto* harmonization (for example, Hronsky and Houghton 2001; Schultz and Lopez 2001; Doupnik and Richter 2003 & 2004; Psaros and Trotman 2004). These studies have established that factors

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<sup>3</sup> In the international accounting literature, *de jure* and *de facto* accounting are also denoted as formal harmonization and material harmonization respectively (see Rahman et al. 2002).

such as culture, professional experience and type of standards impact on the interpretation and application of accounting standards.

The findings of studies that have examined various aspects of harmonization are, however, limited because they have failed to identify the relationship between country-specific characteristics and the selection of the appropriate approach used for the adoption of IFRSs. Greater attention should be given to factors that influence convergence as its application can provide valuable insights for standard-setting processes, especially now that the accounting community is so conscious of the need to advance the harmonization process (Garrido et al. 2002, p.1).

An economically efficient system of financial reporting in countries requires many institutional features, including well-established professional accounting bodies, independent standard setting bodies, and effective and independent regulatory enforcement bodies (Ball 2001; Wulandari and Rahman 2004). Similarly, the Commissioner of US Securities and Exchange Commission (SEC) indicated that “in an ideal world, international accounting standards would operate within a strong infrastructure that would work in tandem with the standards to achieve high quality” (in Casabona and Shoaf 2002, p.20). A number of studies have also shown that infrastructure arrangements are important to enforce consistent use of the standards (see Wulandari and Rahman 2004 for a review).

The countries that adopt the IFRSs have a number of serious problems to address (Schlesinger 2002; KPMG 2003; Hansen 2005). For example, from 2005 the European Union has moved towards an adoption of IFRSs, requiring all European companies listed on a stock exchange in the European Union to follow these standards in their consolidated financial statements (Pacter 2005, p.75). However, the European Union has encountered a number of difficulties in its drive towards convergence (Schlesinger 2002; Hansen 2005). Major obstacles are the differences in the systems of developing and enforcing compliance with accounting standards, and the various cultural and economic

disparities that exist in the respective countries of the European Union. The accounting system of each European Union member country is a product of its own unique cultural, political and economic history, and embedded in its own beliefs in business practices and corporate governance (Haswell and McKinnon 2003, p.10). In other words, major obstacles in the European Union's move towards convergence and harmonization are country-specific.

In this study, the country-specific attributes which will be analyzed as relevant to the approach used in adopting the IFRSs by individual countries are the set of accounting standards that were prevailing in the country at the time when the selection was made, the availability and experience of professional accountants, the relevant education and professional training, the presence of the Big 4 accounting firms, and the accounting regulatory framework.

## **2.22 Framework for Convergence and Harmonization**

Although the terms harmonization, convergence and compatibility are often used interchangeably, they have unique meanings. The Australian Accounting Standards Board (AASB), via paragraph 2 of Policy Statement 4, 'International Convergence and Harmonization Policy' defines 'international convergence' as "working with other standard setting bodies to develop new or revised standards that will contribute to the development of a single set of accounting standards for worldwide use." 'International harmonization' is "a process which leads to these standards being made compatible with the standards of international standard-setting bodies to the extent that this would result in high quality standards" (AASB 2002, p.6). It logically follows that the harmonization process leads to compatibility of standards between countries. The aim of working with standard setting bodies such as the IASB is to achieve convergence, which ultimately leads to a single set of accounting standards for worldwide use.

IFRSs may not be implemented in full or without modification largely because of political, economic and institutional differences among nations. In such cases, the IASB anticipates that its standards could be adopted, albeit with minor modifications (Harding 1999; IASB 2003). Though national standards in most countries of the world are now based on IFRSs, national standard setters do make either small or large changes to those standards (Pacter 2005, p.73). This leads to significant differences in the ways in which the IFRSs are enforced in the countries that have adopted or intend to adopt them.

Broadly, five different approaches for convergence and harmonization exist (see figure 2.1 for details). The various approaches to converge and harmonize range from an adoption of IFRSs in their entirety at one end of the continuum, to the other end of the continuum where there is no convergence and harmonization at all.

<Insert Figure 2.1 about here>

Given the number of approaches that could be used in convergence and the significant differences across nations in country-specific attributes, national standard setters need to identify the approach most suitable for their context. This paper next evaluates the respective approaches used by countries in the South Pacific region and investigates the relationship between country-specific characteristics and the selection of the appropriate approach. However, it should be noted that this paper does not provide any analysis on ‘Continuation with the local accounting standards, but in harmony with the IFRSs,’ as there are no countries in the South Pacific region adopting such an approach.

## **2.30 CONVERGENCE AND HARMONIZATION IN THE SOUTH PACIFIC REGION**

### **2.31 Adoption of IFRSs in their Entirety: Papua New Guinea**

Corporate financial accounting and reporting practices in Papua New Guinea are governed by the Corporations Act (1997) and the pronouncements of the Papua New Guinea Accounting Standards Board (PNGASB). Inaugurated in May 1997, this board is a statutory authority established by an Act of Parliament to formulate and/or approve standards for use in the country as well as to provide the legislative backing to the accounting standards that are promulgated (Asian Development Bank 2000, p.11). The Papua New Guinea standard setters adopted the IFRSs from June 2001. The PNGASB provide major reasons for convergence as follows:

... with the increasingly global nature of capital markets and the liberalization of world trade, if Papua New Guinea is to attract investment and increase its exports it is essential for it to adopt accounting standards which meet international standards. The adoption of uniform accounting standards will also provide an opportunity for greater transparency, and trust by the public in company accounting. This is an important step for the accounting profession and accounting as a whole in Papua New Guinea. (Joint Statement of PNGASB, 2 July 1998)

The Papua New Guinea standard setters have now adopted all the IFRSs in their entirety and have indicated that they will be adopting other new IFRSs that the IASB will introduce and revise. However, two Papua New Guinea Standards, PNGAS 3 *Accounting for Plantations* and PNGAS 4 *Reporting Currency*, are still in use and have been developed specifically for the Papua New Guinea context. These standards are to be applied by all the companies, except those which are ‘exempt’ from complying with all the accounting standards (Asian Development Bank 2000, p.11).

The PNGASB had recommended the use of IFRSs in the country since 1990. Despite the recommendation, most entities had not been complying with these standards, and lacking any legal means to enforce compliance, the standard setters were not able to

discipline companies and professional accountants for non-compliance. However, since 1997 the PNGASB has the legal mandate to discipline companies and professional accountants for non-compliance. This move has also made standard setting officially independent instead of being part of the role of the professional accounting body. With the adoption of the IFRSs, the standard setters have argued that financial reporting in the country is much more rigorous. However, there has been no significant improvement in compliance and enforcement remains a serious problem. For example, the Acting Governor of the Bank of Papua New Guinea, Benny BM Popoitai, in a speech to the external auditors of regulated financial institutes concluded:

I feel the need for Auditors and Accounting Associations of PNG to come down hard on members who do not properly carry out their tasks, be it deliberate or otherwise. Sanctions for such behavior must be punitive and must be enforced and not for show only. Our experiences with some of your members in their roles as external auditors leave a lot to be desired. (2005, p.4)

Prior studies have also provided evidence of the importance of punitive enforcement of accounting standards, finding that it has a significant impact on the credibility of financial accounting information (Wulandari and Rahman 2004, p.6). The Papua New Guinea experience suggests that professional accounting bodies and regulators need to be increasingly involved with monitoring the level of compliance with accounting standards.

The accounting profession in Papua New Guinea is regulated by the Certified Practising Accountants of Papua New Guinea (CPAPNG), which was established under the Accountants Act (1996). In compliance with Section 67 of the Accountants Act, all accountants, whether in the private or public sector, must be members of CPAPNG and registered with the Accountants Registration Board. The CPAPNG broadly has a two-tier membership where all graduates from the accredited universities in the country become 'affiliate' members, and all affiliates who pass the CPAPNG examinations and have three years of supervised or five years of unsupervised work experience become

‘associates.’ The accounting curriculum in tertiary institutions and training programs provided by the institute since 1990 has been based on the IFRSs.

Three of the Big 4 international accounting firms (Deloitte Touche Tohmatsu, KPMG and PricewaterhouseCoopers) are present in the country.<sup>4</sup> The large international accounting firms have facilitated the process of convergence by offering standardized accounting, auditing and other financial services (Cooper et al. 1998, p.531). Papua New Guinea has adopted the IFRSs in their entirety largely because the three big accounting firms provide almost all the accounting services for larger enterprises (Chand 2005, p.216). The same three firms also provide the necessary support to the standard setters in interpreting and adequately applying the IFRSs. They use their experienced professional accountants to apply these standards or can deploy their international counterparts on a ‘fly-in-fly-out’ basis. In contrast, the local accounting firms generally do not have the necessary experience and resources. Overall, findings suggest that Papua New Guinea does not have sufficiently qualified and experienced professional accountants to interpret and adequately apply the IFRSs. However, a number of relevant continuing professional education courses have been introduced to educate and enhance the expertise of the local accountants (Chand 2005, p.217). The experience in Papua New Guinea suggests that adequately interpreting and applying the IFRSs remains a major challenge.

Papua New Guinea has suffered a severe downturn in its economy due to a degree of political instability and a perception that corruption levels are high, which has led to reduced investment (Manning 2001, p.25). Given the political instability and the limited level of international investment in the country, adoption of the entire set of IFRSs was advocated largely as a means to attract funds, especially from multinational enterprises (Joint Statement of PNGASB 1998). In December 2007, however, the Port Moresby Stock Exchange had only fifteen listed companies, being unable to attract multinational

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<sup>4</sup> The fourth, Ernst and Young, is represented by Deloitte Touche Tohmatsu.

enterprises to register. Equity financing in the private sector has consistently remained low.

In summary, this analysis of Papua New Guinea suggests that the following factors may be indicative of a country's readiness and or suitability to adopt the IFRSs in their entirety:

- lack of a well-defined and comprehensive set of accounting standards in the country;
- a reasonable number of experienced professional accountants;
- education and professional training in line with the IFRSs or similar standards;
- the presence of some of the Big 4 accounting firms;
- legal backing for the country's accounting standards and an 'active' independent regulator to facilitate the implementation and enforcement of accounting standards; and
- an increasing portion of equity financing in the private sector or an intention to move in that direction by attracting multinational enterprises.

### **2.32 Adoption of IFRSs Selectively or with a Time Lag: Fiji**

In the Republic of the Fiji Islands, the Companies Act (1983) and the pronouncements of the professional accountancy body, the Fiji Institute of Accountants (FIA), provide the legal and regulatory framework for financial reporting. Authorized to operate as the sole professional accounting body in Fiji by virtue of an Act of Parliament (Fiji Institute of Accountants Act 1972), the FIA established a by-law in 1986 in relation to the formulation and promulgation of accounting and auditing standards in Fiji. The by-law acknowledges the institute's obligation to support standards promulgated by the IASB and the International Federation of Accountants (IFAC) and to use its best endeavors to ensure compliance. The FIA adopted the IFRSs selectively in 2002 and deferred the adoption of the remaining and the new IFRSs to a later date. Prior to this adoption,



generally accepted accounting principles based on a combination of Australian, New Zealand and IASB frameworks were already in place though many standards were largely outdated.

The current set of Fiji Accounting Standards (FASs) is almost exclusively based on the IFRSs and consists of twenty-three mandatory standards and eleven ‘guidance standards.’ The reasons for the issuance of the IFRSs as ‘guidance standards’ are twofold. First, certain standards may not be relevant to Fiji. Examples include IAS 29 *Financial Reporting in Hyperinflationary Economics*, IAS 19 *Employee Benefits*, and IAS 26 *Accounting and Reporting by Retirement Benefit Plans*. IAS 29 addresses a problem that Fiji does not presently experience as the inflation rates in Fiji for the past ten years have remained below 10 per cent per annum. Similarly, IAS 19 and IAS 26 are inappropriate because they relate to reporting entity sponsored pension schemes whereas there are no such employee benefits and retirement benefit plans in Fiji. Secondly, even where standards are relevant entities may experience difficulty in complying because of their complexity (Chand 2003, pp.87–88). This is consistent with the observations made in other jurisdictions that IFRSs may at times be totally irrelevant or complex and require amendments before they can be useful for adoption in emerging economies (Devi 2003; Wong 2004). Mindful of this, the standard setters in Fiji have delayed the adoption of such standards (Tuinamuaana 2005, p.8).

Fiji lacks both an independent accounting standards board and legislative backing for the standards. Nevertheless, even though the establishment of an independent regulator is still to be seriously considered (Asian Development Bank 2002), the level of compliance is satisfactory. For example, Pathik (2000) in her study on the extent of non-compliance with Fiji Accounting Standards showed that the level of compliance by large reporting entities was comparable to that in the neighboring developed countries of Australia and New Zealand. This is largely due to the proactive role of the Fiji Institute of Accountants. The members of the Institute who fail to apply the mandatory standards render themselves liable to disciplinary action under Section 32 of the institute’s by-law

(Fiji Institute of Accountants 1986). Additionally, according to the by-law, non-members of the institute are precluded from providing accounting services to clients. Only FIA members with a chartered accountant (CA) status and at least three years of experience with an established accounting firm are allowed to operate their own accounting firms.

In comparison with Papua New Guinea, Fiji has the presence not only of the Big 4 international accounting firms but also numerous other medium-sized accounting firms. As such, Fiji is reasonably well endowed with the resources and expertise to adopt the IFRSs. Apart from a small proportion of expatriate accountants in the total membership of the FIA, local members generally share common professional educational backgrounds. Most of the accountants receive their academic qualification at the University of the South Pacific, where IFRSs are an important part of the curriculum. However, with a small economy and a limited number of professional accountants, a rather long transitional period for the adoption of the IFRSs has been the preferred approach.

A lengthy adoption period is required because the recent standards issued by the IASB are complex and compared to the earlier standards, require greater exercise of professional judgments. The increased complexity of business transactions, especially in Anglo-American countries, coupled with the focus of the IFRSs to reflect information useful to users of financial statements, has resulted in complex and sometimes overly sophisticated IFRSs, contributing to what has been called 'standards overload' (Confederation of Asian and Pacific Accountants (CAPA) 2003, p.1). Findings show that a majority of professional accountants in Fiji do not have sufficient experience and confidence in exercising professional judgment (Chand and White 2005, p.12). Therefore, professional accountants require relevant training and certainly a time frame to be able to apply these standards in a consistent manner. To this end, the FIA has introduced a system of continued professional education to prepare professional accountants for adequate interpretation and application of the IFRSs.

The FIA has adopted the IFRSs, arguing that the adoption of these international standards will improve financial reporting and will facilitate capital flows into Fiji. For example, the report of the 1999 committee inquiring into Fiji's financial institutions suggested that foreign-owned multinationals should also consider listing on the South Pacific Stock Exchange (SPSE) to attract local investors (Ministry of Finance 1999). The adoption of IFRSs was seen as an incentive for multinationals and local enterprises to register on the local stock market. However, consistent with the Papua New Guinea experience, the adoption of IFRSs has not attained this objective. For example, in December 2007 the South Pacific Stock Exchange had sixteen listed companies, having attracted only four new listings since 2002 when IFRSs were adopted. Evidence shows that in Fiji less than 4% of equity in companies listed on the South Pacific Stock Exchange is held by individuals not directly involved in running the enterprises (Patel 2002, p.46).

In summary, this analysis of Fiji suggests that the following factors may be indicative of a country's readiness and or suitability to adopt the IFRSs selectively or with a time lag:

- a reasonably well-established set of accounting standards already prevailing in the country;
- a reasonable number of experienced professional accountants;
- education and professional training in line with the IFRSs or similar standards;
- the presence of some of the Big 4 accounting firms;
- a general lack of both a legal backing for the country's accounting standards and an independent regulator to facilitate the implementation and enforcement of accounting standards; and
- an increasing portion of equity financing in the private sector or an intention to move in that direction by attracting multinational enterprises.

### **2.33 Adoption of IFRSs with Amendments and Additions to Bring Them in Line with the Local Environment: Australia (and New Zealand)**

Since the inception of the International Accounting Standards Committee (the predecessor of the IASB) in 1973, Australia and New Zealand have been actively involved in the process of harmonization and convergence. With a well-established system of developing, enforcing and monitoring the compliance of accounting standards, coupled with a strong presence of the Big 4 accounting firms, these two countries have participated in the development of IFRSs in various forms. This has included taking leadership roles in developing discussion papers and other research for the International Accounting Standards Committee (now IASB). Currently, a large number of IASB's research agenda projects are managed by partner standard setters, including the standard setters of Australia and New Zealand. For example, Australia and New Zealand are involved with the research agenda project on joint ventures. Australia is also involved with the research project on intangibles and extractive industries (Pacter 2005, p.75). Australia is represented on the IASB with full voting rights, and two Australian representatives have also served as chair of the IASC (Collett et al. 2001, p.172).

Since adopting the IFRSs from 1 January 2007, New Zealand is in the midst of a cathartic change to its accounting regulatory framework. The general approach in the adoption of the IFRSs in New Zealand, as described by the Financial Reporting Standards Board (FRSB) and Accounting Standards Review Board (ASRB), is broadly similar to what has been followed in Australia. Therefore, in this section only the process of adoption of the IFRSs in Australia is discussed.

Australia had made numerous changes to its institutional arrangements and structures for accounting standard setting while adopting the IFRSs. These developments were precipitated by sweeping reforms initiated by the Commonwealth Department of the Treasury under their Corporate Law Economic Reform Program (CLERP) (March 1997) (Jones and Wolnizer 2003, p.375). In particular, CLERP 9, Corporate Disclosure: Strengthening the Financial Reporting Framework was issued in September 2002, which

expanded and strengthened the role of the Financial Reporting Council (FRC) (Commonwealth of Australia 2002). The reforms include the FRC being given the responsibility of overseeing audit independence and standard setting in Australia. CLERP 9 (105) also recommended that Australia should adopt the IFRSs. In order to assist the FRC in achieving convergence, the Parliamentary Secretary to the Treasurer announced an additional A\$2 million in funding to the FRC and AASB, doubling the previous contribution of the government (Jones and Wolnizer 2003, p.376). The justification for convergence is given in CLERP 9 (p.102):

The government has long recognized the benefit to Australia of a common global accounting language. In a globalized economy with large and growing cross-border capital movements, high quality internationally accepted accounting standards will facilitate cross border comparisons by investors and enable Australian companies to access international capital markets at lower cost.

The Australian Accounting Standards Board (AASB) has adopted the Australian equivalents of IFRSs effective from 1 January 2005. The approach taken in adopting the IFRSs in Australia is significantly more onerous than in most other countries, including the European Union (Archer 2004, p.54). While the European Union requires all entities listed on a stock exchange within the European Union to follow IASB standards in their consolidated financial statements, Australia is the first Western country to adopt the IFRSs for all its reporting entities.<sup>5</sup> Now every agenda project of the IASB automatically becomes an agenda project of the AASB and becomes the groundwork for a new or revised AASB standard (Pacter 2005, p.80).

Specifically, four categories of Australian Accounting Standards exist. First, AASB standards with one digit correspond to new IFRSs (for example, AASB 3 *Business Combinations* corresponds to IFRS 3 *Business Combinations*). Second, AASB standards with three digits correspond to previously issued International Accounting Standards (IASs) (for example, AASB 128 *Investments in Associates* corresponds to IAS 28

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<sup>5</sup> Reporting entity is a concept used in Australia to denote all entities that are required to prepare general purpose financial reports under the Corporations Act 2001.

*Investments in Associates*). Third, AASB standards with four digits are AASB original standards for which there is no IAS/IFRS equivalent (for example, AASB 1031 *Materiality*). Fourth, Australian Accounting Standards (AASs) which are issued by professional accounting bodies in Australia and are still in use despite the establishment of AASB (there are five such AASs still in use). While the AASB standards are legally binding by virtue of the Corporations Act 2001, AASs are not mandatory. AASs are issued by the professional accounting bodies and members of the accounting bodies are required to comply with these standards.

While IFRSs are the core standards, a number of amendments are made to these core standards to maintain AASB's 'sector neutrality concept.' This concept operating in Australia and New Zealand binds all reporting entities by a single set of standards, irrespective of which sector they operate in and whether they are publicly or privately owned. When Australian paragraphs are included in the standard to accommodate Australian legislative requirements, the prefix 'Aus' is added to the paragraph. For example, AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, while based on IAS 37, include paragraphs dealing with issues unique to not-for-profit entities. Similarly, AASB 136 *Impairment of Assets*, while based on IAS 36, includes paragraphs dealing with measuring the impairment of assets in the not-for-profit sector (Alfredson 2005; CPA Australia 2006). However, these additions to the IASs/IFRSs do not have an impact on the requirements in relation to for-profit entities. This approach seems to be reasonable, as IFRSs themselves call for the consideration of 'pronouncements of other standard setting bodies' as long as those pronouncements are consistent with "the definitions, recognition, and measurement criteria for assets, liabilities, income, and expenses set out in the IASB framework" (Schwartz 2001, p.3).

It is widely argued that IFRSs are not of a sufficiently high quality because important standards lack detailed disclosure requirements or allow alternative treatment for the same transactions (Schwartz 2001, p.2). In cases where there was lack of detailed disclosure requirements or issues that were not addressed by the IFRSs, the AASB has

maintained its previous set of standards. For example, standards such AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts* have been maintained. Additionally, standards such as AASB 1046 *Director and Executive Disclosures by Disclosing Entities*, which included requirements that go beyond the disclosure required under IAS 24 *Related Party Disclosures*, have been included in AASB 124 (CPA Australia 2006).

A number of IASs also allow for optional treatments for similar transactions (for example, IAS 2 *Inventories*; IAS 7 *Cash Flow Statements*; IAS 16 *Property, Plant and Equipment*; IAS 19 *Employee Benefits*; and IAS 23 *Borrowing Costs*). In adopting the IASs, initially the AASB considered the optional treatments on a case-by-case basis and allowed most of the optional treatments, except that AASB 107 *Cash Flow Statements*, based on IAS 7, permitted only the direct method of presenting the cash flow statements. However, in April 2007 AASB decided that, in principle, all options that currently exist under IFRSs should be included in the Australian equivalents to IFRSs and additional Australian disclosures should be eliminated.<sup>6</sup> Although the IASs have explicit optional treatments the IASB has indicated that it is unlikely to include explicit optional treatments in the new standards it develops. The AASB intends to work closely with the IASB to provide additional guidance and interpretation on important standards. However, this process will require some narrowing of differences by the cooperative efforts of standard setters to lobby for removal of some alternatives incorporated in the

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<sup>6</sup> The AASB had outlined its proposals in Exposure Draft (ED) 151 *Australian Additions to and Deletions from IFRSs*, which was issued in November 2006, and considered constituents' responses to ED 151 in early 2007. Consequently, AASB 2007-4 *Amendments to Australian Accounting Standards Arising from ED 151 and Other Amendments* was issued in April 2007 to make the necessary changes. In particular, the option to use the indirect method for presenting cash flow statements is inserted in AASB 107 *Cash Flow Statements*, the commentary from AASB 119 *Employee Benefits* that Australia does not have a sufficiently active and liquid market for high quality corporate bonds for the purposes of discounting employee benefit liabilities has been removed, the options in AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance* to record non-monetary grants at nominal amounts and to present assets and expenses net of related grants are inserted, the definition of 'separate financial statements' in AASB 127 *Consolidated and Separate Financial Statements*, AASB 128 *Investments in Associates*, AASB 131 *Interests in Joint Ventures*, AASB 1023 *General Insurance Contracts*, and AASB 1038 *Life Insurance Contracts* are amended to be the same as the IFRS definition, and the option to use proportionate consolidation for investments in joint venture entities under AASB 131 is inserted (AASB 2007-4, p.7).

IASs and urging IASB to provide additional interpretive guidance (AASB 2003; AASB 2004a&b).

In April 2004, as part of the transition to IFRSs, AASB issued AASB 1047 *Disclosing the Impacts of Adopting Australian Equivalents to International Financial Reporting Standards*. All reporting entities, including not-for-profit entities, were required to apply AASB 1047, in which paragraph 4.2 required:

... that in respect of financial reports for annual or interim reporting periods ending on or after 30 June 2005 an entity shall disclose in its financial report: any known or reliably estimable information about the impacts on the financial report had it been prepared using the Australian equivalents to IFRSs; or if the impacts are not known or reliably estimable, a statement to that effect. (CPA Australia 2005, p.1)

AASB 1047 also provided a line-by-line reconciliation of Australian Standards with IFRSs.

To facilitate the countries adopting the IFRSs from the beginning of 2005, the IASB had established a 'stable platform' of new and revised standards in March 2004. However, there were numerous developments in the IASB standard setting arena since March 2004. New standards, such as IFRS 6 *Exploration for and Evaluation of Mineral Resources*, were issued and a number of existing standards amended. These developments have far-reaching implications, especially in countries that have already adopted the IFRSs. For example, in Australia over a period of three years (2005–2007) since adopting the IFRSs, three new standards were issued (AASB 6 *Exploration for and Evaluation of Mineral Resources*, AASB 7 *Financial Instruments: Disclosures*, and AASB 8 *Operating Segments*), and a total of twenty-nine 'omnibus standards' were issued to make minor amendments to several existing AASB standards (see AASB website for details: <http://www.aasb.com.au>). The AASB has also issued a number of interpretations that are equivalent to the interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC).



In summary, this analysis of Australia suggests that the following factors may be indicative of a country's readiness and or suitability to adopt the IFRSs with amendments and additions:

- a well-established set of accounting standards already prevailing in the country;
- a significant number of experienced professional accountants;
- well-structured education and professional training;
- a strong presence of the Big 4 accounting firms;
- legal as opposed to professional backing for the country's accounting standards and an independent accounting regulator to facilitate the implementation and enforcement of accounting standards; and
- an increasing portion of equity financing in the private sector and largely developed capital markets and stock exchanges.

#### **2.34 Continuation with the Local Accounting Standards or Countries without a Set of Prescribed Accounting Standards: Other South Pacific Island Nations**

Consistent with Fiji and Papua New Guinea, most other South Pacific Island countries' legal and accounting systems bear the marks of their colonial experiences. In many cases this legacy is English-Australian-New Zealand in origin (for example, Kiribati, Samoa and Solomon Islands), though French (for example, New Caledonia) and American (for example, Marshall Islands) influence is also marked in a small number of nations. Earlier German and Japanese influences are much less apparent.

South Pacific Island nations experience significant fluctuations in economic growth, reflecting the small size, limited resources and relative remoteness of their economies, and their reliance on agriculture and a few key industries (United Nations Development Programme (UNDP) 1997 & 2003). The South Pacific is one of the most heavily aid-assisted regions in the world. Aid flows into the region by way of official development assistance, both bilateral and multilateral, and plays a crucial role in meeting

government development programs and, in many cases, budgetary requirements (UNDP 1997 & 2003). In the earlier discussion the paper has shown that Papua New Guinea and Fiji, the two largest developing countries in the region, have adopted the IFRSs. In this section, the remaining South Pacific Island nations are analyzed.

Consisting of scattered small islands, this category of countries share many common characteristics, such as the average gross domestic product (GDP) per capita of only US\$3,103 and median population of a little over 50,000 (Larmour 2005, p.4). Accounting education in this category of South Pacific Island nations is provided through their local education system and/or aid-sponsored short courses in the country and overseas. For the most part, tertiary education is provided through scholarships under aid agreements with universities in Fiji, Papua New Guinea, Australia, New Zealand and Hawaii, though the numbers of private students from some countries are also growing. Despite this, evidence shows that the education, training and experience of many accountants are inadequate (Dixon 2002, p.20).

Moreover, these South Pacific Island countries do not have well-established professional accounting bodies. Even if professional accounting bodies exist (such as in Tonga, Samoa and Solomon Islands) they tend to lack both financial resources and sufficiently qualified professional accountants. Given the small size of the economies and business operations, these countries have also not attracted international accounting firms. Professional accounting services are usually provided on a 'fly-in-fly-out' basis by international accounting firms largely from nearby countries such as Fiji, Papua New Guinea, Australia and New Zealand. These international accounting firms have also given brief periods of attention, usually through a member of one accounting firm instituting courses and examinations for small groups of students or employees, as part of an aid project (Dixon 2002, p.27). Overall, though, these countries face an acute shortage of qualified and experienced professional accountants.

Most accounting work in these countries relates to managing government and government-owned businesses. With the increasing financial support provided to the South Pacific Island nations by the Asian Development Bank, the World Bank, the European Union and various governments such as Australia, New Zealand, Japan and the US, greater demands for accountability and transparency are being made. In particular, improved accountability has been promoted by Australia through the Pacific Islands Forum (Larmour 2005, p.8).<sup>7</sup> As the external funding diversifies, these South Pacific Island nations are forced to adopt accounting frameworks recommended by the donors for greater transparency and accountability (Asian Development Bank 2002).

The South Pacific Island countries also aim to attract foreign capital. To facilitate this process, Australia proposed the idea of a single currency for the region in 2003. Though the Pacific Islands Forum is yet to formally discuss the proposal, there is considerable debate on the subject of common currency (Jayaraman 2006, p.99). Currently, apart from a handful of multinational enterprises and a few large local enterprises, virtually all the other enterprises in the South Pacific Island nations are essentially small or medium in size. Given the limited resources they have both in terms of qualified accountants and the relevant accounting infrastructure, the adoption of the IFRSs may be difficult. Hence, it is most likely that in the near future the South Pacific Island nations may continue with their older systems, under which multinational enterprises adopt the accounting practices used by parent companies overseas and local business enterprises use the accounting practices of the colonizers.

In summary, this analysis of other South Pacific Island nations suggests that the following factors may be indicative of a country's lack of readiness and or suitability to converge and harmonize with the IFRSs:

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<sup>7</sup> The Pacific Islands Forum has 16 member states, of which Australia, Fiji, New Zealand and Papua New Guinea are member states. It has, as part of its mission, an objective to "foster cooperation between governments and between international agencies" (Pacific Islands Forum Secretariat 2006).

- the lack of a well-established set of accounting standards and well-developed professional accounting bodies;
- a general lack of qualified and experienced professional accountants;
- local accounting practices closely mirroring the practices of the colonizer;
- limited presence of the Big 4 accounting firms (usually on a ‘fly-in-fly-out basis’); and
- a handful of multinational enterprises and only a few local enterprises.

## **2.40 CONCLUSIONS AND IMPLICATIONS**

This paper has provided the evidence to show the relationship between country-specific characteristics and selection of the appropriate approach for the adoption of IFRSs. The country-specific attributes that have been found to influence the selection of the approach for adopting the IFRSs are (1) the set of accounting standards that was prevailing in the country at the time when the selection was made, (2) the availability and experience of professional accountants, (3) the relevant education and professional training, (4) the presence of the Big 4 accounting firms, and (5) the accounting regulatory framework which includes the system of developing, enforcing and monitoring compliance with accounting standards. The results of this study suggest that for the South Pacific region, complete comparability in financial reporting may be difficult to achieve across all countries even after the adoption of the IFRSs. This is because while converging their national standards with the IFRSs, countries in the South Pacific region have used various approaches.

Countries planning to adopt the IFRSs can benefit from an understanding of the experiences of the nations analyzed in this paper. The Australian convergence experience may be useful particularly to those countries with rigorous accounting standards and strong regulatory enforcement mechanisms. On the other hand, other developing countries without a well-established system of developing, enforcing and

monitoring compliance with accounting standards may benefit from the Papua New Guinea and Fijian experiences. The findings of this study illustrate that even if countries are adopting the IFRSs, the real test of convergence is in rigorous and consistent application of these standards across various jurisdictions.

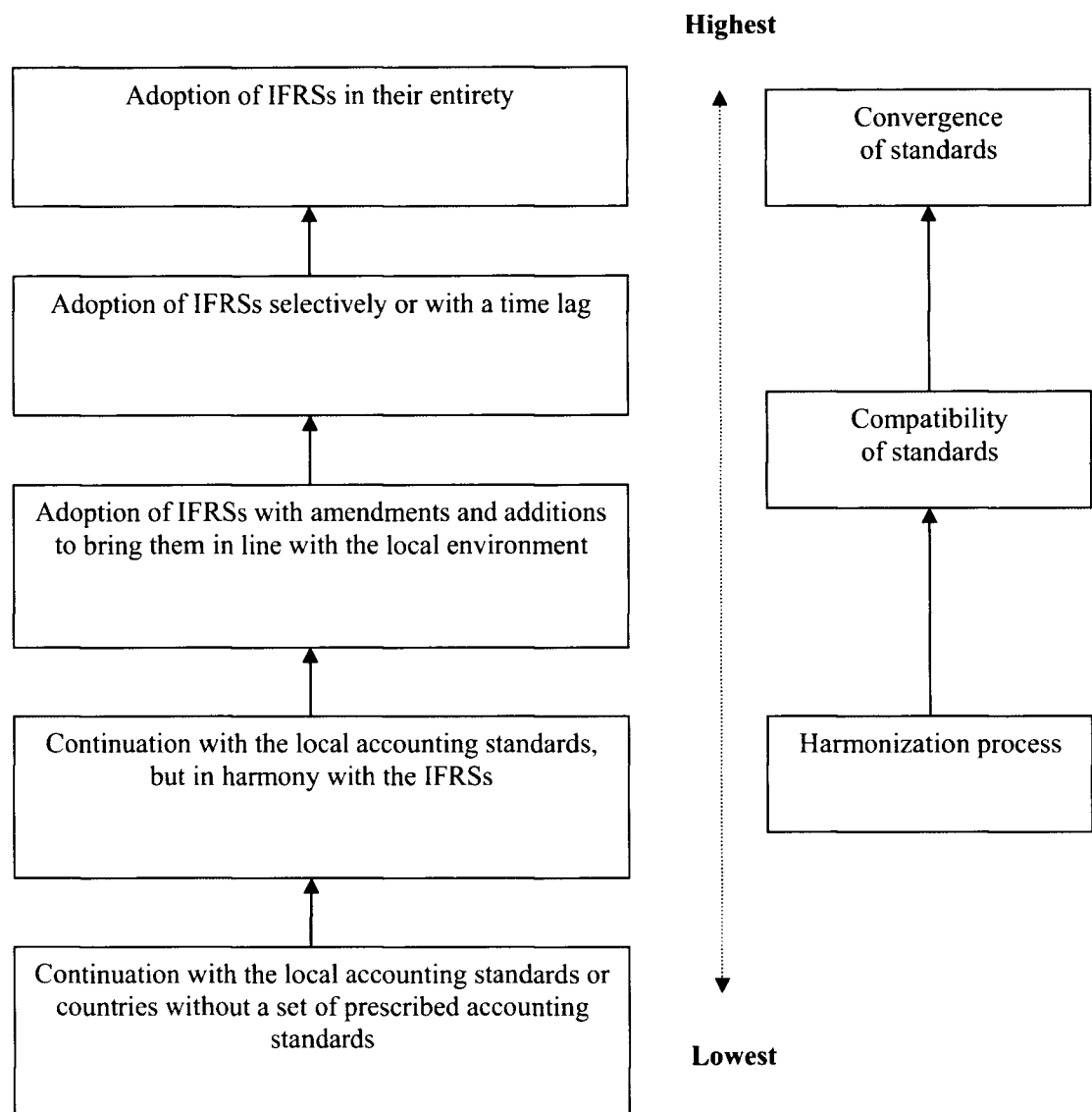
The analysis of Papua New Guinea shows that a country may face difficulties in interpreting and enforcing the IFRSs if it lacks qualified and experienced accountants and supporting regulatory mechanisms. In order to facilitate convergence, an effective enforcement mechanism is necessary. Adequate enforcement would require, amongst other things, a reasonable supply of qualified and experienced accountants and, importantly, a well-established accounting profession and regulatory systems. It is suggested that other countries planning to adopt IFRSs in their entirety may consider assessing the availability of the resources, in terms of both the personnel and the financial resources to be able to support full adoption of IFRSs. Moreover, the findings demonstrate that it is not an easy task for developing countries to adopt the IFRSs and to keep up to date with the developments, given the substantial revisions to the existing IFRSs and new IFRSs being mandated by the IASB. Financial reports are not likely to be useful if professional accountants are not able to interpret and apply the adopted IFRSs in a consistent manner. Implementation and enforcement of IFRSs may be problematic for small South Pacific Island nations.

The findings also show that small countries such as Fiji may find it difficult to adopt all the IFRSs at once. In response to the problems of 'irrelevance' and 'standard overload,' Fiji has chosen selective adoption of IFRSs. Therefore, IFRSs at times may be totally irrelevant or require amendments before they may be relevant for adoption in developing countries. It is suggested that this selective approach is appropriate for those countries that do not have the resources to support the full adoption of the IFRSs or where some of the IFRSs may not be relevant.

The Australian convergence experience demonstrates that the IFRSs omit certain accounting issues and guidance that may be of a particular relevance to a country and contained within the local standards. In adopting the IFRSs, Australian standard setters have incorporated certain issues that are omitted or are yet to be addressed by the IASB. Where applicable, the AASB has included additional guidance in the relevant standards to apply the 'sector neutrality concept.' The analysis demonstrates that in countries such as Australia, which have a well-established system of developing, enforcing and monitoring compliance with accounting standards, a number of amendments to IFRSs may be required to take into account the country-specific contextual factors. The Australian experience also shows that adopting the IFRSs and keeping up to date with the developments is a challenging task, given the substantial revisions to the existing IFRSs and the new IFRSs being mandated by the IASB.

Overall, the findings of this study are likely to be of interest to other countries and regions that may be in the process of identifying the appropriate approach for adopting IFRSs. Future studies may concentrate on empirically testing the effects of the country-specific attributes on convergence efforts across various jurisdictions. In addition, individual-level factors like human judgment factors can also affect convergence of accounting practices. Human judgment factors need further research to see how they affect accounting decisions in a single country and convergence across countries. The findings of such studies may assist national standard setters to identify the approach for adopting the IFRSs most suitable to their context. Further implications and limitations of this study are outlined in Chapter 6.

**Figure 2.1: Approaches of Convergence and Harmonization**



**Table 2.1: Selected Indicators Depicting the Similarities and Differences between the Four Major Countries in the South Pacific Region**

Indicators	Australia	New Zealand	Papua New Guinea	Fiji
<b>Similarities</b>				
Colonial History	British	British	British/Australia	British
Type of Government	Democratic	Democratic	Democratic*	Democratic*
Accounting Model	British-Commonwealth	British-Commonwealth	British-Commonwealth	British-Commonwealth
Accounting Standards	Adopted IFRSs (2005)	Adopted IFRSs (2007)	Adopted IFRSs (2000)	Adopted IFRSs (2002)
Application of Accounting Standards	Reporting entity concept (with differential reporting)	Reporting entity concept (with differential reporting)	Reporting entity concept (with differential reporting)	Reporting entity concept (with differential reporting)
Presence of Big 4 Accounting Firms	All the big 4 accounting firms are present	All the big 4 accounting firms are present	Three of the big 4 accounting firms are present	All the big 4 accounting firms are present
<b>Differences</b>				
Type of Economy	Developed economy	Developed economy	Developing economy	Developing economy
GDP per capita	\$34 943	\$26 994	\$2 908	\$6 032
Population	20 434 176	4 115 771	5 795 887	918 675

\*It should be noted that in recent history, there have been instances of political turmoil in Papua New Guinea and the coup in Fiji (the democratically elected Prime Ministers were overthrown in the coup led by the Military or Rebel groups).



## **CHAPTER 3**

**(Paper 2)**

**Accounting Judgment and Decision Making Research:  
Evaluation of Publications in Top-Tier Accounting Journals  
(1971–2005)**

## **ABSTRACT**

There have been several audit monographs and reviews published on audit judgment and decision making research. These monographs/reviews have strengthened this strand of research by providing insights and suggesting avenues for future research. Although of equal importance, no such comprehensive reviews have been published so far for the research undertaken in the domain of accounting judgment. A review of the accounting judgment and decision making research published during 1971–2005 in the five top-tier accounting journals is reported in this study. This paper adds to the extant literature on accounting judgment and decision making in the following four ways. First, it evaluates the characteristics and significance of these papers and suggests avenues for future research. Second, it reviews and evaluates the theoretical and methodological strengths and weaknesses of these studies. Third, the thematic and methodological review of accounting judgment and decision making research presented in this paper may be useful to improve the research method, theory development and hypotheses formulation stages of future studies. Finally, the analysis presented in this study may also provide the necessary impetus to strengthen this strand of research in the future.

### **Key words:**

Accounting judgment

Decision making

Review

Evaluate

Future research

### 3.10 INTRODUCTION

The financial reports of business enterprises are the end product of numerous judgments and decisions (Hronsky and Houghton 2001, p.123). The accounting standards provide the broad guidelines for preparing these financial reports. Nevertheless, accounting standards only provide accountants with incomplete direction and require accountants to exercise their professional judgment (Brown et al. 1993, p.275). The importance of professional judgment in accounting has long been identified in the literature. For example, Mapp (1937, p.258) argued that “factual information and accuracy in its procurement are essential, but its value is submerged unless with it is synchronized the development and training of the judgment.” Development of the relevant expertise to interpret and apply the various measurement and disclosure rules contained in the accounting standards is of obvious importance for professional accountants given the objective of preparing financial reports which are in accordance with the generally accepted accounting practices. Auditors also need to develop the relevant judgment expertise. For example, Solomon (1995) argued that professional judgment is required in almost all aspects of contemporary financial statement audits.

Moreover, an audit manual of a multinational accounting firm reinforces that “the single most important element in applying the firm’s audit approach is the exercise of informed judgment at the various stages of the audit” (Trotman 1996, p.2). The creation of the *Research Opportunities in Auditing Program* (PMM 1976) and publication of the influential American Accounting Association Report (Committee on Human Information Processing 1977) brought accounting and auditing judgment and decision making into the scholarly limelight (Solomon and Trotman 2003, p.395). The Canadian Institute of Chartered Accountants (CICA) in 1988 also commissioned a major research exercise to examine various issues related to judgments of professional accountants. There has been considerable research undertaken on factors affecting various aspects of audit judgment, including audit planning, internal control evaluation, extent of testing and materiality limits to be used by auditors (see Bonner 1994 and Tan et al. 2002 for

reviews). However, there has been limited research on the factors affecting the interpretation and application of accounting standards.

With regard to accounting judgment, the Treadway Commission in 1987 observed that “bona fide differences of opinion arise in financial reporting, especially if complex or novel transactions are involved. Generally accepted accounting principles may not always be clear on the appropriate accounting treatment and the company and its independent public accountant must use judgment in making a decision” (p.47).<sup>1</sup> While comparing audit and accounting judgments, Mason and Gibbins (1991, p.24) argued that the accounting contexts are quite different, including differences in problems, motivations and analysis, and also a set of different exercisers of judgment where company accountants and managers are responsible for the preparation of financial reports. There have been several audit monographs and reviews published on audit judgment and decision making studies (for example, Libby 1981; Ashton 1982 & 1983; Ashton and Ashton 1995; Bell and Wright 1995; Trotman 1996; Solomon and Trotman 2003; Humphrey 2008). These monographs and reviews strengthened this strand of research by providing an insight into the audit judgment and decision making studies and suggesting avenues for future research. Though of equal importance, no such monograph or comprehensive review has been published so far for the research undertaken in the domain of accounting judgment.

The current study reviews the papers published in five top-tier accounting journals during 1971–2005 that fall within the domain of accounting judgment research.<sup>2</sup> Accounting judgment and decision making studies published in the top five accounting journals as defined by Brown and Huefner (1994) and Solomon and Trotman (2003) are reviewed [*Accounting, Organizations and Society* (AOS), *Contemporary Accounting*

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<sup>1</sup> Report of the National Commission on Fraudulent Financial Reporting (New York, October 1989, p.47).

<sup>2</sup> Papers published after 1971 have been selected for review as the first notable accounting judgment study was published in 1972. The seminal work of Haried (1972) was the first study in accounting which used semantic differential technique to explain the semantic problems in accounting and outlined ways to measure meanings of terms and concepts used in accounting.

*Research* (CAR), *Journal of Accounting & Economics* (JAE), *Journal of Accounting Research* (JAR), and *The Accounting Review* (AR)]. By undertaking a content analysis of all the papers published in the five top-tier accounting journals during 1971–2005, a total of only sixteen papers were identified that can be categorized as part of accounting judgment and decision making research (AOS, 7; CAR, 4; JAR, 5; and none in AR and JAE).<sup>3</sup>

As already noted in Chapter 1, this paper adds to the extant literature on accounting judgment and decision making by evaluating the characteristics and significance of the papers published in the five top-tier accounting journals and suggesting avenues for future research. It also reviews and evaluates the theoretical and methodological strengths and weaknesses of these studies. The limitations identified in this review may be useful to improve the research method, theory development and hypotheses formulation stages of future studies. The analysis presented in this study may also provide the necessary impetus to strengthen the accounting judgment and decision making research in future.

The remainder of the paper is organized as follows. Section two provides an overview of research undertaken in accounting judgment and decision making literature, with details on the journals in which they are published and the number of citations for each study. Sections three to six evaluate in the aggregate the four categories of research undertaken, with particular emphasis on the characteristics and significance of each individual study. The review is organized under the heading: (i) Measuring Connotative Meaning in Accounting (Table 3.2), (ii) Interpretation of ‘Uncertainty Expressions’ in Accounting Standards (Table 3.3), (iii) Effect of Culture on Accounting Judgment and Decision

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<sup>3</sup> All the articles published during 1971–2005 in the five top-tier accounting journals were carefully considered to ensure that all the accounting judgment and decision making studies were included in the analysis. However, there were some studies that were excluded though they may be marginally regarded as part of this strand of research. For example, studies such as Chesley (1975 & 1976) and Wright (1982 & 1988) were excluded as they were primarily concerned about the subjective probability elicitation methods, rather than dealing with direct issues related to the judgments of professional accountants. Moreover, a cursory review of all the articles published during 2006–2007 in these five journals showed that none of them can be regarded as part of accounting judgment and decision making studies.

Making (Table 3.4), and (iv) Conceptual Issues in Accounting Judgment and Decision Making Research (Table 3.5). This section also evaluates the research methods used by the respective studies and suggests avenues for future research. The final section provides the concluding remarks.

### **3.20 OVERVIEW AND SCOPE**

Judgment and decision making research in accounting is part of a larger area of psychological research called ‘behavioral decision theory’ which studies how professional accountants’ judgments and decisions are made and identifies ways to improve them (Trotman 1998, p.115). For the purpose of this study, judgments “refer to subjective assessments made as a prelude to taking action” and decisions “mean actions that people take to perform some task or resolve some problem” (Solomon and Trotman 2003, p.396). For example, in determining the appropriate form of financial disclosure, professional accountants need to interpret and apply a number of broad principles contained in the accounting standards. The judgment and decision making research in accounting has shown that judgments of professional accountants are not made in a vacuum. Studies have shown that a number of factors including level of formal education, accounting firm affiliations, experience, familiarity with financial statements and accounting concepts, and ethnicity (culture) impact on accountants when making professional judgments (Libby and Luft 1993; Bonner 1994; Douppnik and Salter 1995; Nobes 1998; Lin et al. 2003).

The review of the sixteen studies suggests that judgment and decision making research in accounting have four basic aims: (i) to identify the extent of similarity in the meanings of key accounting concepts held by various parties involved in the preparation and the use of financial reports; (ii) to describe how professional accountants interpret and apply accounting standards, in particular examining the ambiguity in interpretation of uncertainty expressions; (iii) to identify the influence of other factors including

national and linguistic culture on the interpretation and application of accounting standards; and (iv) to provide some insight into the theoretical and conceptual issues in accounting judgment and decision making research.

Firstly, there are seven studies (Haried 1972 & 1973; Oliver 1974; Flamholtz and Cook 1978; Belkaoui 1980; Houghton 1988; and Hronsky and Houghton 2001) that tend to measure the extent of similarity in the meanings of key accounting concepts held by various parties involved in the preparation and the use of financial reports. These studies have been published in JAR (4 studies) or in AOS (3 studies). JAR was the first top-tier accounting journal to publish three of the initial studies (Haried 1972 & 1973; and Oliver 1974) which measured the meanings of accounting terms and concepts. The most cited study in this group is that of Belkaoui (1980), with a total of 21 citations, followed by Oliver (1974) with 8 and Flamholtz and Cook (1978) with 6 citations respectively (see table 3.1 for further details on these studies).<sup>4</sup>

Secondly, there are four studies (Chesley 1986; Houghton 1987; Harrison and Tomassini 1989; and Amer et al. 1995) that attempt to examine how professional accountants interpret and apply accounting standards. These studies are separated from the first group as they particularly focus on examining the ambiguity in interpretation of uncertainty expressions.<sup>5</sup> These studies are more recent than most of the research that forms part of the first group. Except Houghton (1987), which is published in AOS, the other three studies have been published in CAR. The citation index for the studies in this group is very similar with 6 citations for Harrison and Tomassini (1989), 5 each for Chesley (1986) and Houghton (1987), and 3 citations for Amer et al. (1995).

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<sup>4</sup> The citations are based on the Science-direct or the EBSCO-host citation index which is included under additional information of the individual articles while downloading them.

<sup>5</sup> Accounting standards use uncertainty expressions (also referred to as verbal probabilities)—expressions which require subjective interpretations and its probabilities “are quantifications of degrees of belief concerning the relative likelihood of events that may affect the choice among decision alternatives” (Wright 1988, p.47). For further details see Chapters 4 and 5.

It is surprising to note that while a number of studies have examined the influence of culture in various decision making contexts, only one study has been published in the top-tier accounting journals which attempts to measure the influence of culture on the interpretation and application of accounting standards. A recent study by Doupnik and Richter (2003), published in AOS, examined the effect of language-culture and linguistic translation on the interpretation of uncertainty expressions found in accounting standards. So far the study has only 1 citation.

Lastly, there are four studies (Belkaoui 1978; Gibbins 1984; Emby and Gibbins 1988; and Brown et al. 1993) that attempt to provide some insight into the theoretical and conceptual issues in accounting judgment and decision making research. The nature of these studies is varied but a common attempt was to provide a better insight into the decision making process of professional accountants and identify potential factors that may affect judgments. Belkaoui (1978) and Brown et al. (1993) were published in AOS, while Gibbins (1984) was published in JAR and Emby and Gibbins (1988) in CAR. The study by Gibbins (1984) is by far the most cited paper that has been reviewed, with a total of 58 citations. Using various judgment theories, research findings and interviews with accountants, the paper derived a number of propositions, corollaries and hypothesis on professional judgments. This study provided the impetus to a number of empirical researches where most of the later studies have attempted to derive additional propositions or tested some of Gibbins’s propositions empirically. Belkaoui (1978) was the second most cited paper in this category, with a total of 13 citations, followed by Emby and Gibbins (1988) with 7, and Brown et al. (1993) with 3 citations respectively.

<Insert Table 3.1 here>

Sections three to six provide a detailed discussion on all the four categories of research under the heading: (1) Overview, (2) Research Methods, and (3) Suggestions for Future Research.



### **3.30 MEASURING CONNOTATIVE MEANING IN ACCOUNTING**

#### **3.31 Overview**

A number of studies have used various techniques to measure the connotative meanings of terms and concepts used in accounting. Of the 16 studies reviewed in this paper, seven studies fall within this domain of research. A few studies have attempted to measure the differences in the meanings of accounting terms and concepts held by various groups of preparers and users of financial reports (Haried 1972 & 1973; Oliver 1974; Houghton 1988); one study has provided some insight into the reasons for the differences in meanings held by various groups (Belkaoui 1980); and others have shown evidence of the link between connotative meaning and decision outcomes (Flamholtz and Cook 1978; Hronsky and Houghton 2001).

Haried (1972 & 1973) were the first published studies attempting to measure ‘meaning’ in accounting. Haried (1972) redefined and adapted Osgood et al. (1957) semantic differential technique to explain the semantic problems in accounting. Osgood et al. (p.377) had developed a semantic differential method (it locates the meaning of a concept as a point in semantic space) which could be used to measure connotative meanings of terms used in the communication process. Haried used the semantic judgments of 157 participants (123 students, 18 CPAs and 16 investment club members) “to generate pairs of potentially relevant adjectives” and “then a factor analysis was undertaken to determine the relationships of the semantic scales to the major independent dimensions of the restricted semantic space of financial report terminology” (p.380). The study made a significant contribution by developing 33 scales which could potentially be used in accounting research. Overall, the refined measurement technique presented in this study provided a very useful method to test and analyze the meanings associated with the terms and concepts used in accounting.

Using his own method developed in the 1972 study, Haried (1973) attempted to measure the meanings of certain accounting concepts across various preparer and user groups. Using a survey questionnaire administered on three respondent groups (students, professional accountants and investment club members) the study found that while “the antecedent-consequent method succeeds, the semantic differential generally fails to distinguish differences in meaning that are important” to preparer and user groups (p.138). Based on the findings, the study concluded that “the type of differences in meaning measured by the semantic differential is not as satisfactory as that measured by the antecedent-consequent method in supporting conclusions that may lead to action regarding the semantic problems posed by the use of a particular term in financial reports” (p.138). Overall, the paper argued that the antecedent-consequent method was better than the semantic differential technique for measuring connotative meanings conveyed by terms and concepts used in accounting (p.143).

Houghton (1988) presented a critical re-analysis of Haried’s (1973) data. The findings were inconsistent with Haried’s original results and showed that “the structure within which accounting meaning is held is, largely, consistent with the seminal work of Osgood et al. (1957)” and “the measured meaning of accounting concepts within that structure is consistent with expectations” (p.263). Contrary to the results of Haried’s (1973) study—that there are no important differences in overall meanings between various parties—Houghton (1988), using a shared three-factor structure (evaluative, potency and activity), showed that significant between-group and between-concept differences exist. Houghton’s critical analysis reinforced the idea that semantic differential technique is a useful tool for measuring meanings associated with terms and concepts used in accounting.

Oliver (1974) also used semantic differential techniques to measure the semantic meaning of eight selected, important accounting concepts. Seven selected professional groups (a group of accounting educators and six groups of professional accountants) that were involved in the production and use of accounting data were sampled to measure the

meaning of accounting concepts. The six professional groups that were sampled had “indicated a much greater (but not unanimous) agreement on accounting concept meanings” (p.312). However, the study showed differences in meaning between educators and professionals. Although the study provided useful insight, Oliver (1974) did not fully explain what was causing the differences between and within the groups of respondents. Directional *a priori* hypothesis were not formulated and no independent variables were specified to explain the results of the study.

Extending the work of Oliver (1974) and in order to provide some insights into the reasons for the differences in the intra and intergroup communications of accounting concepts, Belkaoui (1980) examined the use of a sociolinguistic construct to assess interprofessional accounting linguistic behavior. He formulated *a priori* hypothesis that the perceptions of accounting concepts are a function of professional group affiliation. He examined a number of independent variables including the respondents’ age, the number of accounting courses taken and the familiarity with financial statements and accounting concepts to explain the differences in meaning of accounting concepts among the groups of respondents. By using professional accountants, students, and professors as subjects, evidence showed that differences exist in the communication of accounting concepts among these groups. However, the other four variables the respondents’ age, the number of accounting courses taken and the familiarity with financial statements and accounting concepts were not found to have any significant effect on the accounting concept perceptions of the respondents or on the dimensions considered. Although the study attempted to identify the reasons for the differences in the perceptions of accounting concepts, it failed to identify any independent variables that were causing the effect.

In an exploratory study, Flamholtz and Cook (1978) attempted to provide evidence on the role of connotative meaning in the process of change in accounting. Using a questionnaire survey the study examined how the nature of connotative meaning can influence the readiness of both professional accountants and managers in accepting

proposed changes in accounting. In particular, using the semantic differential technique the study investigated the meaning of Human Resource Accounting (HRA) and a few other selected accounting constructs (including Social Accounting and Financial Accounting). The findings of the study suggest that a 'semantic halo effect' exists that may explain the resistance to new constructs in accounting such as HRA and Social Accounting (p.115). The study concludes that there are at least three dimensions underlying the meaning of the constructs investigated: (1) Evaluative/Utility, (2) Evaluative/Operationalization, and (3) Potency/Benign. The study found that "HRA constructs are perceived by both accountants and managers to be positive on the Evaluative/Utility and Potency dimensions but negative on the Evaluative/Operationalization dimension" (p.132). In a more recent study, Hronsky and Houghton (2001) provided empirical evidence for the effect of measured meaning on accounting judgment. The classification decisions of Australian professional accountants were assessed in the context of regulated changes to the definition of extraordinary items in Australia. The primary result of the study was that "the extraordinary items classification decisions made by auditors were found to be systematically associated with differences in measured meaning of the extraordinary items definition" (p.123). These two studies extended the strand of research in measurement of meaning in accounting concepts by establishing a link between connotative meaning and decision outcomes.

### **3.32 Research Methods**

Most of the studies measuring meaning of accounting terms and concepts have used the semantic differential technique. The semantic differential instrument was initially developed by Osgood et al. (1957) and was capable of measuring the meanings of terms and concepts as a point in semantic space. Haried (1972) provides details about the semantic differential technique as follows:

The measure is obtained by asking individuals to check off on sets of seven gradient scales degree gradients they feel are most indicative of a given stimulus word [for example to measure the meaning of the term 'Control' three adjectival pairings such as planned–unplanned, expected–unexpected and controllable–uncontrollable can be used]. The scales are defined by sets of polar adjectives and represent independent dimensions of a multidimensional semantic space. When a subject judges a concept ... against a series of such scales, each judgment serves to allocate the concept to a point in semantic space. The meaning of a concept is then operationally defined as that point in semantic space specified by a series of differentiating judgments obtained on a representative set of semantic scales. Differences in meaning are then merely functions of the multidimensional distance between two such points. If the scales are sensitive to the terms being tested, the application of this technique may be used to measure: (1) the difference in the interpretation of a symbol between two or more groups [and] (2) the difference in the interpretation of the meanings of two or more symbols by the same group. (p.377)

As Kerlinger (1973, p.581) noted, the semantic differential technique is a “useful and perhaps sensitive tool to help in the exploration of an extremely important area of psychological and educational concern: connotative meaning.” Several studies in accounting have also used the semantic differential technique to measure connotative meanings of terms and concepts used in financial reporting (for example, Haried 1972 & 1973; Oliver 1974; Flamholtz and Cook 1978; Houghton 1988; Hronsky and Houghton 2001). Although Haried (1973) had questioned the reliability of semantic differential technique in accounting, in a re-analysis of his data, Houghton (1988) provided evidence that the semantic differential instrument was indeed a useful tool to measure connotative meanings of accounting terms and concepts.

The overall differences in the meanings of the chosen concepts are usually tested using univariate (ANOVA) or multivariate analysis of variance (MANOVA). Both between and within group differences are usually measured (for example, Houghton 1988; Hronsky and Houghton 2001). These studies have primarily showed significant differences in the meanings of accounting terms and concepts held by various user and preparer groups.

### **3.33 Suggestions for Future Research**

Using the semantic differential technique previous studies in accounting have primarily measured various groups' meanings of accounting concepts and have showed evidence of the extent to which these groups' shared similar meanings of these concepts (Houghton 1987, p.144). As already noted, these studies have primarily used ANOVA or MANOVA techniques to show the level of differences in the meanings of accounting terms and concepts held by various user and preparer groups. While these studies provided empirical evidence of there being differences in the meanings of accounting terms and concepts across various groups, they were not able to identify what the factors causing the difference were (whether it is caused solely by a difference in the connotative meanings held or whether there are some other factor(s) which may be individually or interactively causing the difference). Furthermore, the majority of these studies did not attempt to investigate whether the differences held in the meanings of accounting terms and concepts also caused a difference in interpreting and applying these accounting standards across various groups of professional accountants or across different countries.

With the exception of Hronsky and Houghton (2001), most of the other studies have not examined the actual decisions made by professional accountants on the basis of the concepts. To empirically demonstrate any significant relationship between differences in the meanings of the concepts held and variability in the accounting judgments would be important. As Hronsky and Houghton (2001, p.127) pointed out, it would "establish a linkage between connotative meaning and an accounting decision, and provide some explanation of the role of meaning in accounting decision making." Oliver (1974, p.306) also argued that misinterpretations and misunderstandings in the communication process do not necessarily result from different semantic differential scores only but can also be influenced by decision context, and institutional and source factors. Therefore, future studies in attempting to measure the connotative meaning of terms and concepts may consider the influence of many other factors which may also contribute to variability in

the interpretation of these concepts and the decisions being made (Hronsky and Houghton 2001, p.137).

Additionally, Hronsky and Houghton (2001, p.136) noted that the other most important limitation of these studies is that they tend to measure the connotative meaning only and ignore the literal or denotative meaning which is generally assumed to be shared. This simplistic and dichotomous classification of meaning as denotative/connotative has been criticized (see Harris 1981; Garza-Cuaron 1991; Hronsky and Houghton 2001, p.136). It should also be noted that while semantic differential measures the connotative meanings of terms and concepts, meaning has both denotative and connotative aspects. Bagranoff et al. (1994, p.36) noted that “denotative meaning is a term or concept’s literal definition (for example, the denotative meaning of profit is the excess of revenues over expenses)” whereas “connotative meaning is the emotional aspect of meaning (the connotative meaning of profit might be that it is good, necessary, valuable, and so on).” Osgood et al. (1957) argued that it was the connotative meaning that influenced human judgment and reactions. Studies in accounting have generally found that it is the connotative meanings of accounting terms and concepts which varies across groups of preparers, educators and users of financial reports. This is because the connotative aspect of meaning involves an interpretation or reaction (Bagranoff et al. 1994, p.37).

While the semantic differential technique has been found to be a useful tool to measure connotative meaning, it has to be carefully designed. The instrument often comprises of adjectival pairings and between each pair there are usually seven spaces. The respondents are usually asked to place a check mark on one of the spaces between the adjectives and a number of such scales are used for a single concept (usually ranging from ten to thirty) (Houghton 1988, p.264). A number of studies in the elicitation and experimental decision literature have found that the probability scales used cause a difference in the interpretation of terms and concepts. For example, studies have found a lack of symmetry in interpretations between the 0 to .50 and .50 to 1.00 parts of the probability scale (see Chesley 1986, p.182). Therefore, while measuring the connotative

meaning of a single accounting term or concept, care has to be taken in selecting the appropriate number of adjectival pairings and the spaces used in the scale.

### **3.40 INTERPRETATION OF ‘UNCERTAINTY EXPRESSIONS’ IN ACCOUNTING STANDARDS**

#### **3.41 Overview**

A number of studies have examined the ambiguity in the interpretation of uncertainty expressions used in accounting standards. Of the 16 studies reviewed in this paper, four studies fall within this domain of research (Chesley 1986; Houghton 1987; Harrison and Tomassini 1989; and Amer et al. 1995).

Chesley (1986) attempted to provide a detailed examination of the ambiguity of interpretations in the communication of uncertainty expressions. Average probability levels were computed from responses of 3<sup>rd</sup> and 4<sup>th</sup> year university accounting students to various uncertainty expressions. Additional analyses of interpretations were undertaken by comparing different methods of responding to the communications, using a variety of ways of assessing the impact on interpretations and comparing the responses of various subject groups. The findings showed that “ambiguity exists and that this ambiguity is reasonably stable for the vocabulary of the accountant ... [it] can be increased by the use of difficult response modes by the interpreter but it cannot easily be reduced” (p.179). This study made an important contribution by providing various methods to assess the differences in the ambiguity of interpretation in the communication of uncertainty expressions.

Using a different context, Houghton (1987) examined the shared meaning between professional accountants and ‘private’ (non-institutional) shareholders for the accounting concept ‘true and fair view’ in Australia. The study found that “accountants and shareholders do not share the same meaning for ‘true and fair view’ nor do they share



similar cognitive structures” (p.143). Additionally, accountants could not accurately perceive the shareholders’ meaning. The cognitive structure of the ‘expert’ accountants’ group was seen to be more complex than ‘lay’ private shareholders. Although this was the first empirical study into the connotative meaning of ‘true and fair view’ and provided useful insights, it did not unbundle the various components that could have led to the differences in the meanings of ‘true and fair view’ held by the accountants and shareholders; such unbundling may have allowed further insight into the findings.

The study by Harrison and Tomassini (1989) extended the line of research on uncertainty expressions by specifically addressing the important problem of interpreting an accounting standard. Their study reported the results of research in which experienced auditors interpreted the criteria of Statement of Financial Accounting Standards No. 5 (SFAS 5) *Accounting for Contingencies*, issued by the Financial Accounting Standards Board (FASB) of US. Their research focused on “the nature and degree of consensus in the auditors’ interpretations and the extent to which these interpretations depend upon the type of contingent loss” (p.642). Specifically, the study examined auditors’ interpretations of probability thresholds for ‘remote,’ ‘reasonably possible,’ and ‘probable’ across different types of contingencies. Findings showed little difference in thresholds across the various contingencies, although there was less consensus about the threshold between ‘remote’ and ‘reasonably possible.’ While Harrison and Tomassini (1989) found no effect of context on interpretation of uncertainty expressions, Amer et al. (1995) performed an experiment which examined whether audit managers’ interpretations of the SFAS 5 probability expressions are influenced by one contextual factor—event base rate. Their findings showed that interpretations of the expression ‘probable’ were positively associated with event base rate. Both studies show that there is a possibility that uncertainty expressions may be interpreted differently both between and within groups.

### 3.42 Research Methods

Studies considering the interpretation of uncertainty expressions have attempted to identify the level of consensus amongst professional accountants in their interpretation. Consensus between professional accountants has been the most commonly used measure of the quality of judgments and decisions made both in audit and accounting judgment studies (see Trotman, 1996 for a review of auditor judgment studies). A detailed description on how to measure consensus is given below:

Consensus is usually calculated as the grand mean across individuals, of the mean correlation coefficient with any one individual, or with all other individuals (e.g. Ashton 1974). To illustrate the calculation of mean consensus for a group of subjects, assume that 30 auditors evaluate 32 internal control cases each. In this case, the 32 judgments of auditor 1 would be correlated with those of auditor 2, then auditor 3, etc. The same would then be done for auditor 2, then auditor 3, etc. An average correlation is calculated for each auditor and these are then averaged to provide the average consensus score. The correlation coefficient also can be grouped by experience level and/or application to provide a guide to consensus patterns. (Trotman 1996, p.38)

Correlation analysis is an important method used to numerically quantify the relationship between two variables. Although using correlation analysis to calculate consensus is a commonly used method in audit and accounting judgment studies, it is subject to the construct validity threat. This is because the individual mean scores may be represented by different non-zero intercepts (scaling effects) and this may not be captured by the average correlation coefficients calculated for individuals. To overcome this problem, Trotman and Yetton (1985) used a two-way individual by case ANOVA, where the cue effect measured the agreement in professional judgments across cases and the individual effect measured the auditor main effects (see Trotman 1996, p.39 for further details). Therefore, it is important that studies measuring consensus amongst professional accountants use a number of methods to avoid deriving erroneous conclusions from their results.

Studies reviewed in this section have primarily used various experimental designs to manipulate a number of factors that may affect the interpretations of uncertainty expressions. Various uncertainty expressions have been selected from the accounting standards and its interpretation has been tested using various subjects. Subjects were usually asked to provide a numerical probability (either a single probability from the range 0 to 100 percent or in a range) for each uncertainty expression. Generally, average probability levels (mean values) are computed from responses to all the uncertainty expressions used. A statistical test using ANOVA is then commonly used to compare the variance in the responses.

### **3.43 Suggestions for Future Research**

The prior studies undertaken in accountants' judgment and decision making literature so far provide some evidence that uncertainty expressions contained in accounting standards are interpreted differently by various subjects. However, apart from Harrison and Tomassini (1989) and Amer et al. (1995) no other studies reviewed have made any attempt to identify the causes of the differences in interpretations. A number of factors which have been considered and been found to impact on the judgments of professional accountants in an audit context have not been considered in an accounting context. For example, variables such as level of formal education, experience, age, gender, task complexity, familiarity with internal control procedures and accounting concepts, and ethnicity (culture) have been found to affect the judgments and decision making process of professional accountants. Therefore, future studies examining the interpretation of uncertainty expressions may also consider the factor(s) which may explain the variability in interpretations.

Furthermore, in the audit judgment literature factors such as the impact of task familiarity and complexity have been found to have an impact on professional judgment in various contexts. Prior research in auditing also provides evidence of a possible interaction between task complexity and familiarity (see Asare and McDaniel 1996 for a

review of these studies). However, no prior research has investigated the nature of the relation between ‘complexity’ and ‘familiarity’ in accounting standards and judgments of professional accountants. Such research could usefully be part of future research. This is also important as the accounting convergence process is leading to a number of new standards being formulated and promulgated in many countries.

It is also surprising to note that studies reviewed in this section generally made no attempt to show how these uncertainties are interpreted and applied in providing a relevant financial disclosure. Such research is also important as it would provide some evidence on how professional accountants interpret and apply accounting standards which contain uncertainty expressions in real world situations.

### **3.50 EFFECT OF CULTURE ON ACCOUNTING JUDGMENT AND DECISION MAKING**

#### **3.51 Overview**

A number of studies have been published in other journals which examine the impact of culture on judgments of professional accountants. For example, Davidson and Chrisman (1994) study published in the *Journal of International Accounting, Auditing and Taxation*; Bagranoff et al. (1994) study published in the *Behavioral Research in Accounting* journal; Schultz and Lopez (2001) study published in *The International Journal of Accounting*; and Doupnik and Richter (2004) study published in the *Journal of International Accounting Research*. Overall, findings from these studies have shown that similar accounting terms and concepts are interpreted differently and the related judgments among professional accountants across countries vary significantly. However, only a single study (Doupnik and Richter 2003) has been published in one of the five top-tier accounting journals which examines some aspects of cultural influence on the interpretation and application of terms and concepts used in accounting.

Doupnik and Richter (2003) investigated the effect of language-culture and linguistic translation on the interpretation of uncertainty expressions found in International Financial Reporting Standards. The study used three groups of participants, namely, US and German (English speaking and German speaking) professional accountants. One group of German speakers evaluated uncertainty terms expressed in German and another group in English. The results indicated significant differences in interpretation across the three groups where some differences are attributed to a language-culture effect and others to a translation effect, with the language-culture effect being more pervasive. This study made an important contribution by demonstrating the difficulties associated with translating accounting standards in different languages.

### **3.52 Research Methods**

Studies which consider the impact of culture on the judgments and decision making process of professional accountants have examined various aspects of culture. Culture has been considered at the country level (for example, nationality, ethnicity and language) or at an organizational level (for example, organizational culture of big 4 and non-big 4 accounting firms). Overall, studies assessing the interpretation of uncertainty expressions using culture as the major independent variable have provided some evidence that various aspects of culture (either individually or collectively) impact on the judgments of professional accountants. Using a number of selected uncertainty expressions, the predominant method to measure probability is to ask subjects to provide a numerical probability (either a single probability from the range 0 percent to 100 percent or in a range) for each uncertainty expression. Surprisingly, prior research has shown that there is a lack of symmetry (i.e. probabilities assigned to mirror-image pairs such as ‘probable’ and ‘improbable’ do not sum to 100%) and negative probability expressions are usually further away from the 50% mid-point than the related positive expressions (see Doupnik and Richter 2003, p.15 for a review of these studies).

To measure the differences in the point-estimate interpretations, average probability levels (mean values) are computed from the responses to all the uncertainty expressions and ANOVA is commonly used to compare the variance in responses. Additional post hoc comparisons are also undertaken. For example, Douppnik and Richter (2003, p.25) have used the bonferroni post hoc comparison tests, a “procedure [that] controls the overall error rate by setting the error rate for each post hoc comparison test to the experimentwise error rate (set at 0.05) divided by the total number of tests.”

Generally, the cross-cultural studies use Hofstede’s (1980) and Hofstede and Bond’s (1988) cultural values to cluster countries into different cultural groups. However, studies tend to operationalize culture by relying on a few cultural dimensions. This simplistic treatment of culture by relying on a limited number of cultural dimensions limits theoretical advances in cross-cultural accounting research (Harrison and McKinnon 1999; Patel 1999). The omitted dimension from Hofstede’s (1980) and Hofstede and Bond’s (1988) cultural values must be attended to in the study’s methodology, by matching the cultures’ understudy on this dimension (Harrison and McKinnon 1999, p.489). The ‘pick and choose’ approach and the theoretical omission of relevant cultural dimensions may be a partial explanation for some of the disparity in the research findings which exists (Harrison and McKinnon 1999, p.489). Therefore, the choice (and the omission) of relevant cultural dimension(s) should be based on a theory-driven evaluation.

There is also a need to establish content equivalence in the accounting constructs or issues being examined in cross-cultural accounting research. Content equivalence refers to similarities in the accounting standards, rules, procedures and concepts (Patel 1999, p.131). For example, studies such as Gul and Tsui (1993), Schultz and Lopez (2001) and Douppnik and Richter (2003) have all indicated the importance of establishing content equivalence as a prerequisite for cross-cultural theory development and hypotheses formulation. Additionally, accounting judgment can be looked at in two different but complementary ways, namely, agreement in fact and agreement in principle (Ashton

1982; Trotman 1990). Agreement in fact refers to the similarity of overall judgments while agreement in principle relates to the similarity of judgment policies (Trotman 1990, p.39). Libby (1983) and Trotman (1990) suggested that researchers examining judgments of professional accountants should pay attention to the determinants of performance and argued that greater contributions may come from research that also address the interactions between the determinants. Therefore, content equivalence and various factors which may affect judgments of professional accountants should also be considered in developing the appropriate research design for future cross-cultural studies.

### **3.53 Suggestions for Future Research**

An overarching issue that emerges from the review of the literature is that the models linking accounting judgments and culture show that there is a connection between culture and judgments of professional accountants. However, most professional accountants' judgment studies have relied solely on Hofstede's (1980) and Hofstede and Bond's (1988) cultural values because their model provides quantified measures for cultural accounting values. However, it should be noted that while Hofstede's initial cultural dimensions were statistically significant, they explained only 49 per cent of the differences across countries in his sample (Hofstede 1980; Hofstede and Hofstede 2005). This means that there are either omitted variables or unexplained differences across countries. Child (1981, p.330) argued that in conducting an effective cross-cultural study it is important to theoretically delineate which subcomponents of culture are likely to be determinants of the organizational and behavioral variables at issue, and to postulate those associations in advance of empirical study (Harrison and Mckinnon 1999, p.485). Therefore, it is important to utilize Hofstede's (1980) and Hofstede and Bond's (1988) cultural dimensions to isolate the impact of the culture and also identify which differences can be attributed to culture and which to non-cultural causes. This will enable accounting researchers to provide a robust theory for explaining international

differences in accounting practice (Baskerville 2003, p.5) and judgments of professional accountants.

Although Hofstede's (1980) and Hofstede and Bond's (1988) five dimensional cultural model is a useful starting point, it must be acknowledged that norms and values are only one measure of culture (Triandis 1994, p.133; Patel 1999). An almost exclusive reliance on cultural norms and values and the ultimate ignorance of other perspectives has resulted in a limited understanding of the richness and complexity of cultural differences and similarities (Harrison and McKinnon 1999; Patel and Psaros 2000). Some of the studies examined have used a highly simplistic representation of a nation's cultural environment. For example, Doupnik and Richter (2003) investigated the effect of language-culture and linguistic translation as the variable operationalizing cultural differences among nations. While defensible within the context of their study, official language is not adequate for more extensive analyses of interpretation and application of uncertainty expressions in individual nations because it does not capture the complexities and richness of social and cultural influence.

In many cross-cultural studies, it was assumed that Hofstede's (1980) scores for cultural dimensions were still applicable during the period of the study. It should be noted that Hofstede's cultural scores were based on a survey conducted in 1968–72, and the scores are now more than 30 years old. To address concerns about the contemporary relevance of those scores and ranks it is suggested that studies relying on Hofstede's cultural dimension(s) need to measure those dimensions to confirm whether the scores are still applicable to their specific samples in the 2000s (Patel 1999, p.61). Cultural values which were developed by Hofstede may have become outdated because of globalization and industrial changes in different countries. While cultures, by definition, change slowly, the rapidity and intensity of globalization has the potential to reduce some cultural differences across societies, particularly with generational change (Harrison and McKinnon 1999, p.504).



Baskerville (2003) also criticized Hofstede's model on a similar ground—the tendency to equate cultural groups with countries. The equation of nations and cultures as synonymous is one reason why many anthropologists and sociologists disagree with Hofstede's theorizing (Baskerville 2003, p.8). The data Hofstede used were obtained from surveys administered amongst employees of IBM and it is the ethnicity of those employees that affects their perceptions, attitudes and behavior (Baskerville 2003, p.8). Studies in sociology and ethnography have also shown evidence of diversity in human behavior across different ethnic groups (see Baskerville 2003). Given that most contemporary societies are multicultural in nature, this cannot be easily refuted and has to be addressed as an important dimension in future cross-cultural accounting research, and more so for researchers working with culture as a variable.

Perhaps the last major weakness in the cross cultural studies is a tendency to assume an excessive simplicity about the nature of cultural values and dimensions and to neglect the associated non-cultural variable, which those dimensions cannot capture. For example, most of the studies assessing the differences in judgments of professional accountants were not able to identify what the ultimate cause was for the differences between the judgments of professional accountants or provided mixed results. For example, though Oliver (1974) showed differences in the meaning of accounting concepts held between educators and professionals, the study was unable to identify the cause of differences between and within the groups of respondents. Similarly, while Houghton (1987) identified that professional accountants and shareholders do not share the same meaning for 'true and fair view,' the study was unable to explain what could be the factors causing the differences. In both these studies considering various aspects of professional culture could have provided an explanation. Given the complexity of the relationships between cultural and non-cultural values such as environmental and external factors, it is important to identify the complex combination or interaction of these factors. Even if there is a clear and consistent connection between culture and professional accountants' judgments, many researchers have failed to uncover it. The most useful way forward is therefore not to carry on replicating past studies using

improved data sets or statistical tests, but instead to concentrate upon detailed within and across country studies to unfold the factors affecting judgments of professional accountants.

### **3.60 CONCEPTUAL ISSUES IN ACCOUNTING JUDGMENT AND DECISION MAKING RESEARCH**

#### **3.61 Overview**

A number of researchers have also attempted to provide some insight into the theoretical and conceptual issues in accounting judgment and decision making research. These studies include those, which derive a number of propositions on professional judgments (Belkaoui 1978; Gibbins 1984); identify some of the characteristics of good professional judgment (Emby and Gibbins 1988); and explore the relationship between accounting standards and judgments of professional accountants (Brown et al. 1993).

Belkaoui (1978) is a conceptual paper which uses the Sapir-Whorf hypothesis (emphasizes the role of language as a mediator and shaper of the environment) to derive propositions in accounting. Accordingly, he argues that accounting is a language with lexical characteristics and grammatical rules that will affect the linguistic and nonlinguistic behavior of users. Specifically, in the paper “four propositions derived from the linguistic relativity paradigm are introduced to conceptually integrate the research findings on the impact of accounting information on the users’ behavior” (p.97). The analysis presented in the paper further supports the empirical findings of other studies undertaken in this domain that lexical and grammatical rules of accounting require appropriate understanding and interpretation both on the part of preparers and users of financial reports.

Similarly, Gibbins (1984) using various judgment theories, research findings and interviews with accountants had derived a number of propositions, corollaries and

hypotheses on professional judgments. The ultimate aim of the paper was to provide a better understanding of the process of judgment in a professional setting, in particular, to show what happens psychologically when an accountant exercises professional judgment (p.104). In the twenty-one propositions derived “the public accountant has been portrayed as relying very much on experience and on the supply of workable, efficient, and probably sophisticated judgment templates that experience has brought. Because he or she is very busy and lives within a complicated network of rules and constraints, the public accountant probably does not consciously analyze situations as much as s/he would like, probably does not look ahead and anticipate problems as much as s/he would like, and probably is more defensive and justification-oriented than s/he would like to be” (p.120). An important contribution of this paper is that it sets out an integrated overall view of the cognitive psychology of professional judgment in accounting. A major drawback of this paper, however, is that no attempt is made to test the propositions empirically.

To extend the work of Gibbins (1984), an attempt was made by Emby and Gibbins (1988) to identify some of the characteristics of good professional judgment and also to provide some empirical evidence. They collected descriptive data from professional accountants in five countries (Canada, US, UK, Australia and Holland) on factors contributing to good judgment. Factors such as expectation, outcome and justification perspectives on judgment quality were shown to be of importance to professional accountants. The study also found differences in the perceptions of professional accountants across various levels of responsibility (different positions) on what factors are important. Additionally, the study tested hypotheses about professional accountants’ need for justification in familiar and unfamiliar situations and in situations with varying likelihoods of positive and negative consequences. As expected, the study found that “the need for justification was greater in unfamiliar than familiar situations for all respondents” and “the need for justification was related to differing likelihoods of positive and negative consequences” (p.310). An important implication of this study is

that professional accountants across various ranks may not attribute similar characteristics to good judgment.

Brown et al. (1993) in a conceptual paper further explored the relationship between accounting standards and professional accountants' judgments. Three kinds of professional judgments were identified (semantic, pragmatic and institutional) to provide a better insight into how professional accountants exercise their judgments given the 'incomplete' nature of accounting standards. The paper concludes that accounting standards are incomplete "because they can supply only necessary but not sufficient conditions for making professional (pragmatic) decisions, and because even the necessary conditions are fraught with (semantic) vagueness" (p.287). This paper reinforces the argument that users and preparers need to understand both the logic of accounting standards and the meanings of terms and concepts used in accounting in order to make valid inferences from financial reports. The paper also draws implications for standard setters, professional organizations and courts of law, articulating that a great deal of care has to be taken in preparing and interpreting accounting standards.

### **3.62 Research Methods**

The studies discussing theoretical and conceptual issues in accounting judgment and decision making have used a number of different research methods. Research methods such as surveys, psychological modeling and theories from other disciplines have been used to provide greater insights into how professional accountants interpret and apply accounting standards. Prior research has shown that accounting standards are 'decision-procedure incomplete' which requires judgments (Brown et al. 1993), and professional accountants need to better understand certain lexical distinctions and grammatical rules in accounting to improve their decision making process (Belkaoui 1978). Most of the studies have identified a number of factors that may affect the decision making process of professional accountants, including factors such as environment of the accountants,

types of judgment situations, experience and levels of responsibility (Gibbins 1984; Emby and Gibbins 1988).

Although these studies revealed important theoretical and conceptual issues in the judgment and decision making process of professional accountants, they generally failed to provide any empirical support to their analysis. For example, Gibbins (1984) derived a number of propositions but no attempt was made to empirically test these propositions. With the exception of Emby and Gibbins (1988), the studies reviewed in this section also made no attempt to provide any guideline on how these propositions could be tested using an appropriate research design.

### **3.63 Suggestions for Future Research**

There are a number of avenues for future studies to provide insights into theoretical and conceptual issues in accounting judgment and decision making research. Generally, the lack of research in the accounting judgment literature may well be attributed to the general lack of any theoretical guidance. Although the auditing literature has documented that factors such as complexity, familiarity, experience and level of education individually or interactively affect the audit performance, such research is generally lacking in the accounting judgment literature. In the auditing literature, a number of models have been established to show the various factors affecting judgments of auditors (see Bonner 1994). In contrast, accounting judgment and decision making research has not been able to identify an exhaustive list of factors which may affect the judgment and decision making process of professional accountants. Additionally, while a number of studies have considered the interpretation of uncertainty expressions, little theoretical guidance exists as to how these uncertainties are interpreted and applied in providing a relevant financial disclosure.

Prior accounting research has at times provided mixed results or was not able to provide any conclusive empirical evidence on what may have caused the variability in judgments

of professional accountants. Also there is lack of evidence on what factors make the accounting standards difficult to interpret—is it ambiguity in the terminology (uncertainty expressions) or is it lack of familiarity and appropriate training? Studies assessing such factors can also be part of future research in this domain.

### 3.70 CONCLUDING REMARKS

The primary objective of this paper was to review and evaluate the theoretical and methodological strengths and weaknesses of the accounting judgment and decision making research published during 1971–2005 in the five top-tier accounting journals. A total of 16 papers were identified which can be categorized as part of this strand of research. Primarily, these studies had four basic aims which includes (1) to identify the extent of similarity in the meanings of key accounting concepts across various groups of users and preparers of financial reports, (2) examining the ambiguity in interpretation of uncertainty expressions, (3) to identify the influence of other factors including culture on the interpretation and application of accounting standards, and (4) to provide some insight into the theoretical and conceptual issues in accounting judgment and decision making research. The thematic and methodological trends in these studies have been identified and avenues for future research have been suggested.

The review of accounting judgment and decision making studies has showed that there is limited research on the factors affecting the interpretation and application of accounting standards. In particular, the review showed that there is limited research on the level of ambiguity in the interpretations of ‘uncertainty expressions’ contained in accounting standards. Moreover, it was noted that prior cross-cultural studies generally made no attempt to show how these uncertainties were interpreted and applied in providing a relevant financial disclosure. Therefore, future studies can examine how professional accountants interpret and apply accounting standards, which contain uncertainty expressions in practical situations.

An understanding of the similarities and differences in interpretation of accounting standards by professional accountants within and across countries would assist in achieving the objectives of accounting convergence. Overall, it is expected that the review of accounting judgment and decision making research presented in this paper will be useful to improve the research method, theory development and hypotheses formulation stages of future studies in this domain. Further implications and limitations of this study are outlined in Chapter 6.

**Table 3.1: Summary of Accounting Judgment and Decision Making Studies**

Study	Journal	Data Collection Method	Number of Citations
Haried (1972 & 1973)	JAR	Questionnaire Survey and BDM Experiment	4, 5
Oliver (1974)	JAR	Questionnaire Survey	8
Belkaoui (1978)	AOS	Other	13
Flamholtz and Cook (1978)	AOS	Questionnaire Survey	6
Belkaoui (1980)	JAR	Questionnaire Survey	21
Gibbins (1984)	JAR	Other	58
Chesley (1986)	CAR	BDM Experiment	5
Houghton (1987)	AOS	Questionnaire Survey	5
Emby and Gibbins (1988)	CAR	Questionnaire Survey	7
Houghton (1988)	AOS	Other	1
Harrison and Tomassini (1989)	CAR	Questionnaire Survey	6
Brown, Collins and Thornton (1993)	AOS	Other	3
Amer, Hackenbrack and Nelson (1995)	CAR	BDM Experiment	3
Hronsky and Houghton (2001)	AOS	BDM Experiment	1
Doupnik and Richter (2003)	AOS	Questionnaire Survey	1



**Table 3.2: Measuring Connotative Meaning in Accounting**

Study	Focus of study	Country (sample size) (subjects)	Methodology	Major Findings
Haried (1972)	Connotative meaning in accounting	US 123 Students 18 Professional accountants 16 Investment club members	Semantic differential technique	Presented the refined measurement technique to test and analyze the meanings associated with terms and concepts used in accounting.
Haried (1973)	Connotative meaning in accounting	US 92 Professional accountants, students and investment club members	Antecedent consequent method and semantic differential technique	Provided evidence that antecedent-consequent method was better than semantic differential technique for measuring connotative meanings in accounting.
Oliver (1974)	Connotative meaning in accounting	US 741 Professional accountants, educators and users of accounting information	Semantic differential technique	Some differences in perceptions of the meanings for educators when compared with other six professional groups.
Flamholtz and Cook (1978)	Connotative meaning and decision outcomes	US 44 Managers 56 Professional accountants	Semantic differential technique	The findings suggests that a 'semantic halo effect' exists that may explain the resistance to new constructs in accounting such as Human Resource Accounting.
Belkaoui (1980)	Connotative meaning in accounting (reasons for differences)	Canada 49 University accounting students 44 Canadian professors 45 Professional accountants	Multi-dimensional scaling techniques	Differences exist in communication of accounting concepts among the three groups.
Houghton (1988)	Connotative meaning in accounting	Haried (1973) data	Semantic differential technique	Semantic differential technique is a useful tool for measuring meanings associated with terms and concepts used in accounting.

Table 3.2 cont...

Study	Focus of study	Country (sample size) (subjects)	Methodology	Major Findings
Hronsky and Houghton (2001)	Connotative meaning and decision outcomes	Australia 40 Professional accountants	Semantic differential technique	The classification of extraordinary items was systematically associated with differences in measured meaning of the extraordinary items.

**Table 3.3: Interpretation of ‘Uncertainty Expressions’ in Accounting Standards**

Study	Focus of study	Country (sample size) (subjects)	Methodology	Major Findings
Chesley (1986)	Uncertainty expressions	US 36 (Experiment 1) and 18 (Experiment 2) 3 <sup>rd</sup> and 4 <sup>th</sup> year university accounting students and 2 <sup>nd</sup> year MBA students	Statistical techniques	Ambiguity exists in the communication of uncertainty expressions.
Houghton (1987)	Accounting concept ‘true and fair view’	Australia 22 Professional accountants 28 Private shareholders	Semantic differential technique	Accountants and shareholders do not share the same meaning for ‘true and fair view’ nor do they share similar cognitive structures.
Harrison and Tomassini (1989)	Uncertainty expressions	US 45 Professional accountants	Statistical techniques	Little difference in thresholds across the various contingencies (SFAS 5), although there was less consensus about the threshold between ‘remote’ and ‘reasonably possible.’
Amer, Hackenbrack and Nelson (1995)	Uncertainty expressions	US 133 Professional accountants	Statistical techniques	Interpretations of the SFAS 5 probability expressions are influenced by one contextual factor—event base rate.

**Table 3.4: Effect of Culture on Accounting Judgment and Decision Making**

Study	Focus of study	Country (sample size) (subjects)	Methodology	Major Findings
Doupnik and Richter (2003)	Language culture and linguistic translation	US, Germany, Switzerland and Austria 299 Professional accountants	Statistical techniques	Some differences in the interpretation of uncertainty expressions are attributed to a language culture effect and others to a translation effect.

**Table 3.5: Conceptual issues in Accounting Judgment and Decision Making Research**

Study	Focus of study	Country (sample size) (subjects)	Methodology	Major Findings
Belkaoui (1978)	Propositions on professional judgment	N/A	Analytical Linguistic relativity paradigm	Lexical and grammatical rules of accounting require appropriate understanding and interpretation both on the part of preparers and users of financial reports.
Gibbins (1984)	Propositions on professional judgment	N/A	Analytical	Derives 21 propositions, corollaries and hypothesis on professional judgments.
Emby and Gibbins (1988)	Characteristics of good professional judgment	Canada, US, UK, Australia and Holland 69 Professional accountants	Analytical and Statistical techniques	Factors such as expectation, outcome and justification perspectives on judgment quality were shown to be of importance to professional accountants.
Brown, Collins and Thornton (1993)	Relationship between accounting standards and professional judgment	N/A	Analytical Demski (1973) Impossibility theorem	Users and preparers need to understand both the logic of accounting standards and the meanings of terms and concepts used in accounting in order to make valid inferences from financial reports.

## **CHAPTER 4**

### **(Paper 3)**

#### **Judgments Based on Interpretation of ‘New’ and ‘Complex’ International Financial Reporting Standards within a Country: Evidence from Fiji**