IMPACT OF AUDIT QUALITY ON ACCOUNTING POLICY DISCLOSURES: IMPLICATONS ON REVENUE RECOGNITION POLICY

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Preliminary Version
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Abstract

Accounting policy disclosures are important parts of financial reports as addressed by standard-setters and They provide value relevant information to decision makers on choices taken by executives. The importance of reported revenue and its use in earnings management makes revenue recognition policy disclosure especially critical for user of financial statements. However, guidance provided by both IASB and FASB is limited and confusing on revenue recognition policy disclosure. The motivation for this study is to provide insight on revenue recognition policy disclosures in IFRS reporting environment. Concurrently, study investigates the current state of revenue recognition policy disclosures after IFRS adoption in Turkey. Additionally, we investigate the impact of audit quality on revenue recognition policy disclosures. Analysis conducted in two stages to show more general results in all sample firms and provide detailed analysis in a small sample of big firms because of their economic transactions richness. Results show that audit quality measured by big 4 and non-big 4 auditors, firm size, length of disclosure and time is not related to accounting policy disclosure. Thus, it can be concluded that the preparation of revenue recognition policy disclosure is related to companies rather then auditors. This also shows the need for guidance and oversight for accounting policy disclosures provided to firms and calls auditors to direct their attention on audit of accounting policy disclosures.

Keywords: Accounting Policy, Revenue Recognition, Audit Quality, Turkey, Big 4

Importance of Accounting Policy Disclosure

According to IAS 8, accounting policies are defined as; "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements[1]." Additionally, US GAAP defines accounting policies as "the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances" and "have been adopted for preparing financial statements". It notes that accounting policies can affect the financial statements significantly, and that the usefulness of statements "depends significantly on the user's understanding of the accounting policies followed by the entity"(AICPA, 1970). According to US GAAP, annual reports are required to include a description of all significant accounting policies of the reporting entity. Such disclosures are to encompass important judgments as to the appropriateness of principles relating to recognition of revenue and allocation of assets costs to current and future periods and those accounting principles and methods that require a selection from existing alternatives, are peculiar to the industry in which the reporting entity operates or represent unusual or innovative applications of GAAP.

Critical accounting policies are the three, four or five policies that are both very important to the portrayal of the company's financial condition and results, and that require management's most difficult, subjective or complex judgments often because they require estimates about the effect of matters that are inherently uncertain (SEC 2002).

Disclosure quality reflects the overall informativeness of a firm's disclosures and depends on the amount, timeliness, and precision of the disclosed information. Healy, Hutton and Palepu [1999] find that firms exhibit a great deal of discretion when determining the amount of information to disclose, the level of detail to provide, and the timeliness with which to convey information, for both mandatory reports and purely voluntary disclosures.

[1] Extracted from IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors. IASC Foundation.

Examining the disclosures of critical accounting policies made by companies reporting according to IFRS provides an opportunity to assess responses to a principles-based standard as well. Research of accounting policy disclosures, which requires complex and subjective judgments by management, provide evidence on how managers interpreted the principles-based guidance and on the other factors that may have affected managers' disclosure of critical accounting policies.

According to contemporary corporate governance approach, management, auditors, and audit committees are responsible for selection, monitoring and discussion of accounting policies. Management is responsible for defending the quality and reasonableness of the accounting policies. Auditors are responsible for satisfying themselves regarding the selection, application, and disclosure of these policies. The audit committee is to be apprised of the evaluative criteria used by management in their selection of these policies.

Many scholars argue that the extent to which standards are enforced and violations prosecuted is as important as the standards themselves (e.g., Sunder [1997, p. 167]). In particular, the quality of financial information is a function of both the quality of accounting standards and the regulatory enforcement or corporate application of the standards (Kothari [2000, p. 92]). Absent adequate enforcement, even the best accounting standards will be inconsequential. If nobody takes action when rules are breached, the rules remain requirements only on paper. In some environments, for example, firms behave toward "mandatory" requirements as if they were vol- untary (Marston and Shrives [1996]). To illustrate, even though accounting policy disclosures are required in most countries as well as by IAS 1 (e.g., Saudagaran and Diga [1997]), Frost and Ramin [1997] document considerable variation in accounting policy disclosures within and across countries.

Revenue Recognition Policy

Discussion paper (Financial Accounting Series, 2008) published by FASB on Revenue recognition states that; Revenue is a crucial part of an entity's financial statements. Capital providers use an entity's revenue when analyzing the entity's financial position and financial performance as a basis for making economic decisions". For this reason, corporate executives are under significant pressure to aggressively recognize revenue. Financial engineering with respect to revenue is also used to meet market expectations, obtain better contracting costs, meet financial covenants, and capture higher market capitalization (Altamuro, Beatty, and Weber, 2002). For some industries, gross margins and sales are the key metrics used to assess a company's prospects and performance (Chlala and Landry, 2003). The pressure on executives to increase revenue emphasizes the importance of revenue, and the pressure brought on professional judgment in this area.

Over a five-year period (July 1997 to July 2002), the SEC launched 227 investigations of suspected financial misreporting, 126 of them relating to revenue recognition (Gillies, 2003). Improper timing of sales was the biggest offence — "borrowing" from the next quarter in an effort to meet market expectations for the current quarter. The SEC also found 80 cases of utterly fictitious revenues and 21 cases of improperly valued revenue. Then SEC chair Lynn Tumer (2001) stated that revenue recognition was the largest single issue involved in restatement of financial statements.

In 2002, as part of its process of reviewing financial and non-financial disclosures made by public companies in the US, SEC reviewed all annual reports on Form 10-K filed by Fortune 500 companies and noted a substantial number of companies did not provide any critical accounting policy disclosure. Among others revenue recognition policy related problems, especially in some industries like computer software, computer services, computer hardware and communications equipment, capital goods, semiconductor, and electronic instruments and controls, energy and retail, were significantly affecting the understandability of the financial statements.

On the other hand, since the use of IFRS by countries increasing by years, a considerable attention has also been given to the quality of IFRS reports. For example in 2007, The Institute of Chartered Accountants in England and Wales (ICAEW) has prepared the EU Implementation of IFRS and the Fair Value Directive Report to demonstrate the recent situation in the EU (ICAEW, 2007). One of the main findings of the report is that for the substantial majority of companies' financial reports, the accounting policies are either the repetition of the exact wording in the appropriate IFRS or are standard summaries of that wording. According the report, one of the frequently occurring examples of the problems is revenue recognition accounting policies that summarize IAS 18 Revenue rather than explaining how and when the company recognizes revenue on its particular transactions. The report also provides summaries of some country observations on accounting policy disclosure as follows:

> The Finnish regulator FIN-FSA comments in its review of the IFRS consolidated financial statements of Finnish publicly traded companies:
>
> 'Accounting policy description should be disclosed on issues that are relevant to the company's business. In many financial statements, it remained unclear whether and how the disclosed accounting policy was relevant to the company's business. Some companies for example presented in the section of accounting policies a definition of investment property although they did not have any assets classified as investment property in their balance sheet.'
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> In its report on the 2005 IFRS consolidated financial statements of publicly traded companies in the UK, the FRRP observed:
>
> *"There was also a tendency for companies to include boilerplate descriptions of accounting policies. In some cases, it appeared that the wording of accounting policies had been copied from the relevant standards with no indication of company specific application.*
>
> *Standardized disclosures have a limited use especially when the policy is prescribed by IFRS. Descriptions of accounting policies are more useful when they identify issues relevant to a company's individual circumstances. For example, revenue recognition policies may need to describe the methods applied to determine the stage of completion of transactions involving the rendering of services. As the methods used will vary according to the nature of the circumstances it is helpful that the policy includes specific relevant details"*
>
> The AMF, the French securities regulator, urged French publicly traded companies to improve:
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> *'It should be stressed, however, that disclosure presented under the heading significant accounting policy must not simply reproduce the main provisions of the accounting standards in question. This would have little informative benefit and*

> *would probably drastically inflate the volume of the notes. Information tailored to the specific characteristics of the entity is of more interest to the user.'*
>
> The AMF paper gives revenue recognition as an example of the problem. It suggests: *'A mere mention that revenue is recognized when acquired is too brief to enable the user to understand the major element of the entity's activities.'*

In 2006 the US SEC staff reviewed the annual reports of around 30 foreign private issuers containing financial statements prepared for the first time on the basis of International Financial Reporting Standards. During the review staff asked a number of companies to provide additional information or disclosure about revenue recognition, especially where a company provided generic policy disclosure and did not provide disclosure specific to its circumstances. When a company did not address all material revenue-generating activities, they asked it to do so. In some instances, they asked questions about the scope and timing of revenue recognition (SEC 2006a).

Both US GAAP and IFRS have problems related to revenue. In U.S. GAAP, revenue recognition guidance comprises too many standards which can produce conflicting results for economically similar transactions. In IFRS, the principles underlying the two main revenue recognition standards (IAS 18, Revenue, and IAS 11, Construction Contracts) are inconsistent and vague, and provide limited guidance[2].

Under these circumstances it is especially important for financial statement users to gain insight to revenue recognition policies of companies from revenue recognition policy disclosures. Unfortunately, concern remains whether financial statement notes generate sufficient clarity for the readers or provide camouflage for actual revenue recognition policy changes (Conrod and Cumby, 2006).

This study is conducted to investigate the current state of revenue recognition policy disclosures after IFRS adoption in Turkey. Additionally, we investigate the impact of audit quality on revenue recognition policy disclosures.

[2] Information for Observers on IASB meeting on April, 2008 states revenue recognition as one of the fundamental deficiencies in IFRS that require completion as a high priority follows; "…revenue is fundamental to financial statement analysis, and the existing guidance in IAS 18 is incomplete, insufficient, and internally inconsistent. We need to recognize that IAS 18 often is applied with US GAAP as a backstop".

Methodology

Data analysis is conducted in two stages. In the first stage, an overall investigation of revenue recognition policy of ISE listed non-financial companies reporting in accordance with IFRS is conducted where data was available between the years 2003-2007. At this stage, whether, companies report revenue recognition policy, the quality of revenue recognition policy, and auditor quality of these companies are investigated. In the second stage, deeper analysis regarding the quality of revenue recognition policy is conducted on non-financial firms at ISE-100 index. This sample is chosen because; bigger firms are expected to have more complicated revenue related transactions, so their revenue recognition policy is expected to be richer.

In our analysis, we assessed the sample firms' revenue recognition policies by using SEC's approach on what should be exist in an ideal revenue recognition policy disclosure. According to "Current Accounting and Disclosure Issues in the Division of Corporation Finance" report dated November 30, 2006, the Division of Corporation Finance US SEC, revenue recognition disclosure should be viewed as follows (SEC 2006b):

> Since revenue recognition is often a critical accounting policy, registrants should review the completeness and accuracy of disclosures concerning their sources of revenues, method of accounting for revenues, and material considerations in evaluating the quality and uncertainties surrounding their revenue generating activity. The disclosure should be concise and to the point; more disclosure is not necessarily better. Basic descriptive information about revenue generating activities, customary contract terms and practices, and specific uncertainties inherent in the registrant's business activities may be most appropriate in Description of Business. Descriptive information about the effects of variations in revenue generating activities and practices, or changes in the magnitude of specific uncertainties, is most appropriate in MD&A. Accounting policies, material assumptions and estimates, and significant quantitative information about

revenues should be included in notes to the financial statements or in MD&A, as appropriate. Some disclosure examples follow:

<u>Disaggregate product and service information</u>

• Report product and service revenues (and costs of revenues) separately on the face of the income statement.

• Furnish separate revenues of each major product or service within segment data

• Describe the major revenue-generating products, services, or arrangements clearly

• For major contracts or groups of similar contracts, disclose essential terms, including payment terms and unusual provisions or conditions

<u>Disclose when revenue is recognized (examples)</u>

• Upon delivery (indicate whether terms are customarily FOB shipping point or FOB destination)

• Upon completion of service

• After commencement of service, ratably over service period

• Upon satisfaction of a significant condition of sale – (identify the condition)

  o Only after customer acceptance?

  o Only after testing?

• Upon completion of all terms of contract

• Over performance period based on progress toward completion

• Upon delivery of separate elements in multi-element arrangement

<u>If revenue is recognized over the service period, based on progress toward completion, proportional performance, or based on separate contract elements or milestones, disclose how the period's revenue is measured</u>

• Disclose how progress is measured (cost to cost, time and materials, units of delivery, units of work performed)

• Identify types of contract payment milestones, and explain how they relate to substantive performance and revenue recognition events

• Disclose whether contracts with a single counterparty are combined or bifurcated

• Identify contract elements permitting separate revenue recognition, and describe how they are distinguished

• Explain how contract revenue is allocated among elements

o Relative fair value or residual method?

o Fair value based on vendor specific evidence or by other means?

Disclose material assumptions, estimates and uncertainties

• Disclose contingencies such as rights of return, conditions of acceptance, warranties, price protection, etc.

• Describe the accounting treatments for the contingencies

• Describe significant assumptions, material changes, and reasonably likely uncertainties

• Special disclosures and conditions are specified by SAB Topic 13 for companies that recognize refundable revenues by analogy to FASB Statement No. 48, Sales With the Right of Return. "

Findings

Findings of first stage analysis are provided at Table 1. Results show that, percentage of companies that state revenue recognition policy increases through years. This can be attributed to the experience gained in IFRS application. However, an increasing percentage of companies through years found to be reporting exact wording of IAS as revenue recognition policy in their reports. This result implies that, even though there is an increase in policy reporting firms, most of these firms does not report revenue recognition policy in its intended spirit.

The last column of Table 1 show percentage of companies that use exact wording of IAS that are audited by big four auditors. Even though the results show improvement by time, it is striking that there is no implication of high audit quality on revenue recognition policy disclosures. This led us to believe that the preparation of revenue recognition policy disclosure is related to companies rather then auditors.

INSERT TABLE 1 HERE

In the second stage, deeper analysis regarding the quality of revenue recognition policy is conducted on non-financial firms at ISE-100 index between 2003-2008. The sample consists of 297 firm year observations as shown in Table 2. These firms are those prepared their financial reports according to IFRS. The firms in 2003 and 2004 were

early and others were mandatory IFRS adapters. Financial firms were excluded from the sample because they have different characteristics and are subject to different regulations.

INSERT TABLE 2 HERE

We first investigated the nature of revenue recognition policies in terms of whether firms clearly identified goods and/or service revenue recognition policies in their disclosures. We classified policies into four types as

- Not specified: firms provided revenue recognition policy but there's no specific criteria such as delivery, acceptance of goods or services given.
- Partial disclosure: firms provided revenue recognition policy but not for all products and services, or there is conflicting criteria.
- Full disclosure: firms provided revenue recognition policy and there are specific criteria such as delivery, acceptance of goods or services given.
- No clear disclosure: firms provided revenue recognition policy and the criteria given does not clearly address the policy and having two conflicting criteria such as delivery or acceptance for the same group of goods and services.

As shown in Table 3, 156 of 297 observations (52 %) provided full and clear disclosure whereas 108 of 297 (36 %) observations do not provide any disclosure.

INSERT TABLE 3 HERE

Since auditor plays a very important role in the disclosure of accounting policies further analysis has been conducted on the impact of audit quality on accounting policy disclosure. Audit quality is measured as big-4 and non-big-4 audit companies consistent with previous literature. Results are provided at Tables 4 and 5 which classifies findings reported at Table 3 by big 4 or non-big 4 auditors.

INSERT TABLE 4 HERE

INSERT TABLE 5 HERE

When results presented at tables 4 and 5 are compared, it can be said that audit quality does not affect policy disclosure much. Table 4 shows that, 49 of 93 non big-4 audited companies had full disclosure on revenue recognition policy. This is 53% of the total. Table 5 shows that, 107 of 204 big-4 audited companies had full disclosure on revenue recognition policy. This is also 53% of the total.

An important line of policy disclosure research focuses on the length of the policy disclosures in terms of the number of the words used. Table 6 shows the average number of words used to disclose revenue recognition policies. As seen in Table 6 average number of words draws an increasing trend through years. An interesting observation is that the difference between full disclosure firms and not specified firms is very small. This result points to the fact that the length of disclosure does not relate to disclosure quality.

INSERT TABLE 6 HERE

Another important question to ask is to see if firms change revenue recognition policy through years and if auditor change is connected to revenue recognition policy change. The results show that in 2004-2007 periods, number of no-policy change firms exceeds policy change firms. However in 2008 number of policy change firms exceeds the number of no-policy change firms.

INSERT TABLE 7 HERE

INSERT TABLE 8 HERE

Moreover, Table 8 shows that auditor change does not seem to affect policy change.

Conclusion

Results interpreted together shows that both in full sample and big firms sample number of companies that do not provide proper disclosure increases through years. For big

companies, number of firms that provide full disclosure increase after year 2005, mandatory adoption year, but stays the same afterwards. Interestingly, percentage of full disclosure firms is equal for big-4 and non-big 4 audit companies. This shows that quality of policy disclosures is not related to audit quality. Additionally, length of disclosure is not related to disclosure quality even though the length of policies increases through years. When policy changes are investigated, it is seen that number of policy changes increase through years but its relation to auditor change can not be interpreted properly due to data limitations.

The results of the study shows the need for guidance and oversight for accounting policy disclosures provided to firms and calls auditors to direct their attention on audit of accounting policy disclosures.

Number (%) of companies which state a revenue recognition policy	Number (%) companies which Took Their Revenue Recognition Policy from IAS 18	Number (%) companies which Took Their Revenue Recognition Policy from IAS 18 and are audited by One of the Big 4 Companies

Table 1: Results of preliminary analysis

Table 2: Non-financial ISE 100 firms those have IFRS reports

Table 3: Firms revenue recognition policy disclosure (goods and services)

Table 4: Revenue recognition policy disclosures of firms those were audited by non-big 4 firms

Table 5: Revenue recognition policy disclosures of firms those were audited by big 4 firms

Table 6: Average number of words used to disclose revenue recognition policy

NO POLICY CHANGE	POLICY CHANGE

Table 7: Accounting policy changes by years

NO AUDITOR CHANGE	AUDITOR CHANGE

Table 8: Relationship between auditor changes and the revenue recognition policy changes