The Impact of Standard Precision on the Principle of Transfer of Control

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Executive Summary

IASB and FASB (the Boards) proposed a single revenue recognition standard in the Exposure Draft (2010) *Revenue Recognition in Contracts with Customers*, which would replace current IFRS and U.S. GAAP revenue recognition standards. The purpose of this study is to provide the Boards with research results that might be useful in finalizing the amount and type of guidance to be provided in the joint standard.

Under the proposed standard, the concept of transfer of asset control is central to the revenue recognition principle. Guidance with respect to this concept will be very important in the application of the new revenue recognition standard. Possible guidance in applying the general principle of control could include (1) a list of key indicators that provide criteria to be considered in determining whether the customer obtains control, and (2) illustrative examples, which can be either affirmative (describing a situation in which the customer has control), or counter (describing a situation in which the customer does not have control). How the standard is applied and the extent to which it results in comparable revenue recognition across entities could depend, at least in part, on the type and level of guidance included in the standard. This leads to our research questions: (1) What is the relative impact on control judgments from adding indicators, examples, or both to the standard? (2) Does the type of illustrative example (affirmative or counter) affect judgments? (3) Does any effect of example type vary by the level of standard precision?

To address the research questions, we conduct an experiment, using 434 accounting students as subjects, in which we elicit subjects' judgments with respect to the transfer of control in a construction-type contract. We provide subjects one

of six different hypothetical standards that contain some combination of (1) principle (and explanation) of control (P), (2) four indicators of control,[1] and (3) an illustrative example, either affirmative (A) or counter (C), containing four cues related to the four indicators.[2] We then ask subjects to apply the standard to a hypothetical case containing four key facts (related to the four indicators and the four cues contained in the examples), and indicate the extent to which they feel control has been transferred to the customer as well as their level of confidence in their judgment. To give our manipulations of type and level of guidance an opportunity to have an effect on judgments, we create an ambiguous situation by providing two positive facts (i.e., facts that support a judgment that the customer has control) and two negative facts in each case.

We find that adding additional guidance to a principle-only standard, regardless of whether in the form of indicators or examples, and whether the example is affirmative or counter, results in subjects being more likely to judge the customer as having control during the construction period. However, the addition of indicators has a larger effect than the addition of an example. This is consistent with the responses we obtain to a post-experiment question asking what information subjects used most in making their decisions; subjects generally indicate that the indicators were used more than the examples. We find that the nature of the example does not matter when added to a principle-only standard, but it does matter when added to a standard that also contains key indicators. Specifically, subjects are more likely to judge the customer as having control when a counter example is added to key indicators, but they are less likely to judge the customer as having control when an affirmative example is added to key indicators.

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[1] Indicators that the customer has control of an asset are: (1) the customer specifies the design or function of the asset, (2) the customer has an unconditional obligation to pay for the asset, (3) the customer has physical possession of the asset, and (4) the customer has continuing managerial involvement in the asset.

[2] The six versions of the hypothetical standard are: (1) Principle only (P), (2) Principle + Indicators (P + I), (3) Principle + Affirmative Example (P + A), (4) Principle + Counter Example (P + C), (5) Principle + Indicators + Affirmative Example (P + I + A), and (6) Principle + Indicators + Counter Example (P + I + C).

We find that increasing standard precision, through the introduction of either indicators or an example, does not significantly affect subjects' confidence in their judgment as compared to the principle-only standard. However, adding both indicators and an example does result in a significant increase in subjects' confidence in their judgment.

The effect of increasing standard precision on the variability in judgments (comparability) differs depending on whether indicators or examples are added to the principle-only standard. Adding indicators decreases the variability in responses, whereas adding examples increases that variability.

Our results suggest that different combinations of standard components can affect judgments based upon the standard, the level of confidence in applying the standard, as well as the variability with which the standard is applied. The questions of how much and what type of guidance to provide in an accounting standard are not unique to the topic of revenue recognition but are general questions that must be considered by the Boards. These questions are especially important in the development of so-called principles-based standards. Whether the specific results we obtain in the context of revenue recognition in construction-type contracts are generalizable to other settings is open to empirical investigation.