CHAPTER FIVE

SUMMARY AND GENERAL DISCUSSION

This thesis on accounting choice has taken its starting point in the paradigm of Positive Accounting Theory, an economics-based approach which aims to explain and predict accounting choices made by management of reporting entities. Although explicit references to Positive Accounting Theory have become scarce, its basic concepts still pervade many lines of current accounting research. However, its aspiration to explain and predict can only be realized in practice on the basis of suitable data about the incentives and costs involved in accounting choices. In practice, accounting choices are to a large extent dependent on specific circumstances. Even under the assumptions of a rational-choice setting, the number of factors to be considered quickly increases if we allow that other parties, such as the external auditor, may also play a role in accounting choice. To date, the positive accounting research tradition, has therefore yielded just a small number of empirically established general regularities in accounting practice. Notwithstanding this limitation, research based on the positive accounting framework can contribute to our knowledge if we accept that further progress will consist largely of situation-specific findings representing small pieces of a larger puzzle that will gradually reveal more of the complex variations in accounting practice.

In this spirit, in this thesis I report on aspects of accounting choice from an economics-based perspective in specific settings, including both managerial considerations and aspects of the role of the external auditor. As will be explained in the next sections these specific settings (the hospital sector in Chapter 2 and the social housing sector in Chapter 3 and 4) allow me to study accounting and auditing drawing on specific features of financial reporting in these settings.

The remainder of this chapter is organized as follows. In Section 5.1 I will discuss the findings and implications of my research. In Section 5.2 the limitations of my research are discussed together with directions for future research.
5.1. Findings and Implications

5.1.1 Findings and implications Chapter 2

In Chapter 2, I study earnings management in the Dutch Hospital sector by analyzing the timing of recognition of postponed revenue. I show that previous research on earnings management in the hospital sector might be influenced by methodological issues and that these results should be interpreted with care. The specific rules regarding the funding of the Dutch Hospitals gave me the opportunity to develop a new measure for earnings management. The individual hospital budget is based on a set of parameters including the expected number of treatments negotiated by the hospital and the health insurance companies. This preliminary budget is the amount of revenue recognized in the financial statements. Of course, the real volume will differ from the agreed-upon volume and the hospital and the health insurance companies will negotiate ex-post adjustments to the parameters. The final budget is determined (several) years after the year-end, and the difference with the preliminary budget can be positive and negative. These differences or budget corrections are recorded as gains and losses in the year of settlement (if it takes more than one year to settle the budget, also in subsequent years budget corrections can be added for those items that both parties agreed on) and not as restatements of previous years’ financial statements, and have to be separately disclosed. This unique feature gives the opportunity to compare the reported profit in the financial statements with the amount of profit assuming no budget corrections or if the corrections had been recognized in the year they relate to. This new measure of a significant discretionary component in earnings is not, or at least less, subject to the kind estimation errors that characterize commonly used proxies for discretionary accruals (such those based on the Jones model, so some of the methodological issues in earlier research are absent. I used this measure to show that Dutch Hospitals smooth their earnings in line with their incentives.

The contribution of this chapter is fourfold. Firstly, I show that drawing on setting-specific features of accounting can help limiting methodological issues in previous research on earnings management. Secondly, the earnings management literature on the not-for-profit sector is rather limited. In this chapter I add to this literature documenting how earnings management takes place
in the not-for-profit sector. Thirdly, the findings give practical insights to auditors, drawing their attention to the relationship between specific funding arrangements that may apply to not-for-profit entities and management of the reported numbers in the financial statements. Finally, if the earnings management influences the funding decisions and results in misallocation of funding and wasted resources, my findings are relevant for policy makers and health insurance companies.

5.1.2 Findings and implications Chapter 3

The research setting for Chapter 3 is formed by the Social Housing Associations in the Netherlands. Social Housing Associations have the option to value their real estate in their financial statements at historical cost, with the current value disclosed in the notes, or at current value. The interesting feature of this setting is that all Social Housing Associations have to file detailed information, among which information about their real estate and information needed to calculate its current value, with the Dutch social housing supervisor. Based on this information, the supervisor calculates its own measure of the current value. This independently determined benchmark forms the basis of the research reported in Chapter 3. In that chapter I study the influence of leverage on the choice of measurement basis (historical costs versus current values) as well as on the carrying amount of the real estate in the financial statements of Social Housing Associations, in relation to the benchmark established by the supervisor.

As expected I find that more leveraged Social Housing Associations are more likely to choose current value instead of historical cost as their measurement basis. I also find that both under historical cost and under current value, Social Housing Associations influence the carrying amount of their real estate in line with the incentives implied by leverage. However, those Social Housing Associations that use current values as their measurement basis behave less opportunistically in comparison to those that use historical cost as a measurement basis. The latter result is surprising. Proponents of historical costs tend to argue that historical costs are less relevant, but at the same time more reliable and warn for the discretion offered under current value. My research does not support that using current values is generally associated with more opportunistic reporting. The findings suggest that it is only in cases of inadequate processes and
governance that there is ground for fears of discretion and lower reliability associated with the use of current values. These findings, if they can be extended to the for-profit sector, provide additional insights that are relevant to the ongoing debate about the extent to which financial reporting should be based on current value measurements.

5.1.3 Findings and implications Chapter 4

Audit quality is an important constraining factor in accounting choice. Research has shown that audit quality is affected both by characteristics of the audit firm (for example by its general audit methodology and IT environment) and by characteristics of the individual auditors employed in the audit (e.g., competence). One line of research has focused on audit expertise and has shown that audit quality is positively affected by both firm expertise and audit partner expertise. The interaction between firm expertise and partner expertise has been scarcely examined, however. This might be caused by data limitations (in the past the names of the audit partners that sign the audit opinions were typically not publicly known), but there have also been few attempts to develop hypotheses on the nature of this interaction. Expertise, either at firm level or, to the extent that this has been studied, at partner level, is typically proxied by market share. Firm market share is just the summation of the market shares of individual audit partners, but it is likely that firm-level expertise is a more complex concept than just the summation of individual partners’ expertise. The partners’ collective experience is also affected by, for instance, in the firm’s general audit methodology and the IT environment, and, because of the effects of redundancy and mutual reinforcement, will not be a simple addition of individual expertise. In this chapter I begin to explore the relationship between firm-level expertise and individual expertise. I study the effects on audit quality of individual audit partner industry expertise in relation to the expertise of identified colleague audit partners active in the same industry. I introduce the concept of ‘assembled expertise’ to indicate an different level of analysis between the individual auditor and the firm as a whole. I study the effects of individual expertise, collegial expertise, and their interaction on audit quality. I use market share as the basis for individual expertise and various proxies for collegial expertise. Audit quality is based on the same benchmark as used in Chapter
3: for those Social Housing Associations that use current value for balance-sheet measurement of their real estate, audit quality is proxied by the difference between the carrying amount of the real estate in the financial statements and the value of the real estate as determined by the financial supervisor. I find that audit partner industry expertise is positively associated with audit quality. Collegial industry expertise only spills over to individual audit partners if these colleagues have a relatively high level of expertise. The positive effect of the industry expertise of the audit partner and the industry expertise of the colleagues on audit quality are additive. The spillover effects are lower when the audit partner who signs the opinion is an expert himself.’.

Previous research made a distinction between individual audit partner characteristics and firm level characteristics. By introducing the notion of assembled expertise, I point the way to analysis at a different level i.e., between individual audit partner expertise and firm level expertise. This research approach is relevant to both academia and practice. For academia this is relevant because this approach gives the opportunity to do a more refined analysis that goes further than the assumption that firm level expertise is the sum of expertise (market share) of all individual audit partners within that firm. This opens up many research opportunities like, how do audit partners share knowledge and how does this influence audit quality. In practice my results might influence a company’s choice of both the audit firm and audit partner.

5.2. Limitations and directions for future research

The different methodologies applied in the different chapters have their own limitations as discussed there. In this part I want to reflect on these limitations, as well as on the opportunities for further research which they suggest. Some of the limitations are inherent to economics-based research on accounting choice. Others are inherent in my setting, or reflect choices made in my research designs.

The economics-based accounting choice literature assumes that observed accounting behaviour can be predicted using economic decision variables. In practice, and in any setting, the relevant economic decision variables will not be fully known, and the degree to which accounting choice can be explained on the basis of known variables may be relatively low. While I do find
evidence of accounting choice consistent with economic incentives drawn from earlier research, and while it is plausible that these incentives operate in my settings, not much is known in any detail about the economic consequences of accounting choices in my settings, as in the not-for-profit sector generally. Why would boards of hospitals and social housing associations make accounting choices to influence the financial statements? What has the board to gain by choosing certain accounting policies? What are the costs and benefits of accounting choices? What role does, for example, the health insurance company (Chapter 2) and the regulator (Chapter 3) play? More research into the actual role played by financial statements in supporting economic decisions, and into the costs and benefits involved in financial statement preparation and financial statement use would be welcome.

A general limitation of economics-based approaches is that accounting choices may also be driven by non-rational reasons and/or non-economic factors. Even while the distinction between economic and non-economic factors is not necessarily clear cut, it is clear that dimensions such as power, legitimacy, culture, competence and knowledge may well be important in accounting choice. In my setting, for instance, it is plausible that accounting choice is also influenced by the individual preferences of managers or supervisory board members, formed by their diversity of experiences within or outside of the sector, and colored by different perceptions of the appropriateness of conservatism in the context of the governance of social housing provision or hospitals, or of the appropriateness of transferring reporting values and practices from the for-profit to the not-for-profit sector. One could for example examine the influence of ‘the level of conservatism’ of the supervisory board members on the measurement basis chosen (historical cost or fair value) and subsequently ask: do more conservative board members require less aggressive reporting?

A general issue in accounting choice research is that many choices are not easily observable, as illustrated by the well-known difficulties of separating discretionary from non-discretionary accruals. We still do not know much about how accruals behave absent earning management (McNichols, 2000). In this PhD thesis I show that using specifics of the research setting creates opportunities for observing accounting choices that may not generally be available. This is both a strength and a weakness, in that the internal validity of my measures are high, but
my measures are not directly applicable to other settings. I suggest that more research into specific funding or governance mechanisms in the not-for-profit sector, and their relation with accounting choice, is a fruitful path to follow.

In Chapter 3 I report that more leveraged Social Housing Associations are more likely to choose current value as their measurement basis than historical cost. Both under historical cost and under current value Social Housing Associations influence the carrying amount of their real estate in line with the incentives implied by leverage. However, for Social Housing Associations that use current value as their measurement basis, the evidence of opportunistic accounting choice is weaker than for those that use historical cost as their measurement basis. As indicated in Chapter 3, this finding is not in line with general perceptions that current value, or fair value, creates greater risks of earnings management compared to cost-based measures. It would be interesting to examine this issue in the for-profit sector and see whether opportunistic behaviour is more strongly associated with historical cost measurement than with current value measurement.

In Chapter 4 I introduced the concept of ‘assembled expertise’ and study the effect of assembled audit partner industry expertise on audit quality and showed that industry expertise of colleagues affects individual audit partner’ audit quality. We still do not know how audit partners share knowledge with their fellow audit partners. What roles do other team member play in knowledge sharing? This is still a black box. This means I only studied outcomes, but if we want to understand what causes the effects of assembled expertise on audit quality we need to know more of the process of knowledge sharing within audit firms. And if we know more about the process, audit firms can develop policies to improve audit quality using the expertise of the colleagues in the firm, via knowledge sharing. Moreover, I show associations between audit quality and assembled industry expertise, but this research only limitedly informs us about the importance of these factors in relation to other determinants. More and different research is needed to add those pieces of the jigsaw puzzle. Finally, in more and more countries and sectors the names of the signing audit partners are disclosed. This offers many research possibilities to increase the limited number of empirical studies on the effect of audit partner characteristics on audit quality. Future research could examine whether (capital) markets and regulators respond to differences in audit quality related to individual auditor characteristics.
This thesis benefited much from my experience as an auditor. For example, in Chapter 2 I study whether hospitals administratively shift revenue (both positively and negatively) to future periods. This idea occurred to me because I observed this behaviour at one of the hospitals we audited when I was still working at PwC. I also noticed that some Social Housing Associations were more aggressive in determining the parameters relevant for calculating the current value and that some audit partners spent much more time on reviewing these calculations and asked more ‘insightful questions’ than others. These observations formed the basis for Chapter 3 respectively Chapter 4. So, I think that researchers could benefit more from specialists with field experience, like auditors and I plead for more interaction between academia and practitioners.