

# What are the arguments for regulations accounting essay

[Business](#), [Accounting](#)



In the repercussion of the Asian Financial Crisis of 1997 and the corporate accounting scandals such as Enron and WorldCom in the U. S., regulators and standard setters have requested for improved corporate transparency and presented significant changes to accounting standards and regulations. The paper investigates two research questions. First, we consider significant arguments on whether accounting and financial reporting should be regulated through accounting standards. Second, the paper has been examined the idea of what kind of standards should be adopted to regulate accounting and financial reporting. By looking at this, we analyse the characteristics of ‘ principles-based’ and ‘ rules-based’ standards based on United States Securities Exchange Commission (SEC). It then goes on to look at the argument of the agreement on ‘ principles-based’ standards are meant to be more useful than ‘ rules-based’ standards given by regulators, professional bodies and accounting academics. Furthermore, the paper discuss the problems of standard setters have in promulgating principles-based standards. The paper concludes by asking whether the adoption of accounting standard is worthwhile.....

## **What are the arguments for and against regulations?**

Madsen (2011) advocates that standardisation can potentially spread expert knowledge and enhance consistency. He suggests reporting regulation could reduce the litigation risk to auditors by providing justification decision.

Auditors can justify their professional decisions or actions by using standard to show they are follow the best practices, and thus increase the value of their professionalism. He further noted this results in greater consistency will benefits to users of standardized products and services in relation to develop

network externalities, which means the value of a product or services increases with the number of users (Madsen, 2011). In addition, Luez (2010) maintains the benefit of standardisation in accounting regulation is producing wide market cost savings. For instance, it would be easier for users to manage information and make comparison across others. It can be even save more costs if it requires disclosures that firms are willing to provide voluntarily. The requirement saves the cost of negotiating disclosures with many parties when the result does not vary much across firms, it means the costs of conforming with a one size fits all regime are low (Luez, 2010). She further contends that regulation of reporting is most likely to produce optimal level of disclosure. Bushman and Landsman (2010) agree and support by saying because failure to disclose will affects the decision of investors, thus firms will have influential incentives to disclose information in order to achieve higher prices as they are concerned about maximising their value. This makes market observer to presume that the firms trying to conceal bad news and hence bid down the price of the firm (Bushman and Landsman, 2010). In contrast, unregulated reporting would be an issue to severe market failure like externalities (Luez, 2010). Despite they provide a basis for mandating the optimal level of disclosure, which could potentially create negative externalities. It would be problematic for regulators to mandate the right level of disclosure as optimal level of disclosure is likely to be context- and firm-specific and it is rely on the purpose of reporting regulation (Luez, 2010). She added regulation is commonly generated by complex political processes which will affect the firm's level information. It affects the financial regulation structure and accounting standard setting

particularly accounting information is likely to influence the stability of the banking system and financial markets. The problem is political influence driven discretion to financial institutions in crisis might have destabilized market by reducing bank transparency, thus causing more difficult for investors to measure risk of banks(Luez, 2010). It has also been argued that reporting regulation cannot be considered one regulation solution will not fits all countries when considering disclosure regulation (Bushman and Landsman, 2010). Accounting standards must take into consideration of political regimes, economic, culture climate and institutional development, as different countries differ in many aspects. The fact is that the influence of different countries on accounting is often ignored and society would assume that accounting standards are rigid. A significant concern results from the corporate accounting scandals such as Enron and Worldcom is that accounting standards in U. S. are based on rules-based standards which has made the standards longer and more complex. To address these concerns, the U. S. Congress responded to concerns through Sarbanes-Oxley Act, in which required the United States Securities Exchange Commission (SEC) to conduct an investigation into the move towards from rules-based to principles-based standards. Consequently, this regulation has driven the SEC and FASB to consider reforms designed to prevent aggressive financial reporting (Agoglia, Douppnik and Tsakumis, 2011). The conclusion of the study was that ‘ Principle-Based’ standards are better than ‘ Rules-Based’ standards.

## **What are the characteristics of ‘ principles-based’ and ‘ rules-based’ standards?**

According to numerous sources including the SEC, FASB, ICAS and majority researchers recognize the rules-based standards characteristically provide high level of detailed implementation guidance with bright-line thresholds, which results of greater comparability of financial statements. The standards include scope and legacy exceptions, which means certain types of arrangements are exempted from the general principles underlying the standard and instead follow special financial reporting treatments which typically result in inconsistencies in financial reporting (Schipper, 2003). It has been suggested that the exceedingly detailed reporting guidance might encourage transaction structuring and incentive consistent standard interpretation to achieve desired accounting treatments (FASB 2002). Moreover, it results to a “ show me where it says I can’t” attitude, which in turn lead to dysfunctional financial reporting behaviour (Agoglia, Douplik and Tsakumis, 2011). The characteristics that distinguish treatments between ‘ rules’ and ‘ principles’ are suggested by the characterization of ‘ principles-based’ standards conducted in the SEC Study. In its Report SEC (2003), principles-based standards are characterized as being based on a consistently applied conceptual framework. They further noted that principles providing sufficient appropriate details and structures, hence the standards can be operationalized and applied on a consistent basis (Alexander and Jermakowicz, 2006). Moreover, principles-based can be avoiding too much detail and override the objective underlying the standard, the accounting principles clearly stating the accounting objectives of the

standard with an appropriate amount of implementation guidance (Maines, 2007). In addition, principle-based accounting is to minimize exceptions and avoid the use of bright-line tests as that allow companies to achieve technical compliance with the standard while avoiding the intent of the standard (Benston, Bromwich and Wagenhofer, 2006). ICAS added and identified another characteristic, stated that accounting principles allow for the exercise of judgement as well (ICAS, 2006). The FASB believes there are two main differences between principles-based and rules-based standards. First, the principles would apply more broadly than rules-based, in the way that producing few, if any, exceptions to the principles. Second, there would be less informative and implementation guidance in applying the standards. These results would causes greater professional judgement consistent with the intent of the standards (FASB, 2002). SEC (2003) supported the improved principles-based standards and highlight that they are most favourable accounting standards as they provide a constricted framework which would limit the scope of professional judgement, nonetheless allow more flexibility than rules-based standards (Benston, Bromwich and Wagenhofer, 2006)..

### **Why are ‘ principles-based’ standards thought to be more useful than ‘ rules-based’ standards?**

SEC expressed the concern of rules-based standards often provide internal inconsistencies, exceptions and bright-line tests which would led to financial statements that are not representationally faithful to the underlying economic substance of transactions and events (SEC, 2003). Prior accounting literatures highlight the major use of principles-based standards is its broad guidelines that which can be practiced to various situations. Shipper (2003)

and Nelson (2003) emphasize that broad accounting principles evade the difficulties in relation to accurate requirements that allow contracts to be written specifically to manipulate their intent. They discovered a 1981 study reveals that providing bright guidelines may improve the representational faithfulness and discovered that managers structure leases as operating leases in order to evade unnecessary liabilities (Shortridge and Myring, 2004). Unlike rules-based standard, this approach is significantly different from the ' box-ticking' approach (Shortridge and Myring 2004). Both SEC (2003) and FASB (2002) believe principles accounting encourage accountants to utilize their professional judgement in evaluating the substance of a transaction which will results in more meaningful and informative financial statements. It is strongly supported by FASB Chair Robert Herz, says it would enhance the expertise knowledge of financial reporting if accountants apply their judgement instead of relying on detailed rules accounting (FASB, 2004). Both the SEC and FASB claim to support the idea of principles-based standards as rules-based have become excessively complex and detailed with too many rules (SEC, 2003; FASB, 2004). As suggested by Congress, principles-based accounting would be easier to comprehend financial statements and more effectively in investment and credit decisions (Maines, 2007). Users will not need to know detailed rules and exceptions to understand financial statements. Robert Herz (2004) stated that accounting principles would result in a simpler standards as it would be less than 12 pages long rather than 100 pages longer (Shortridge and Myring 2004). The AAA Financial Accounting Standards Committee (2003) expresses principles-based standards are likely to achieve the

financial targets of FASB in place of rules-based standards, which reveal further consistent standard interpretation and therefore develop individual's understanding of the FASB's conceptual framework (Benston, Bromwich and Wagenhofer, 2006). As Australian Securities and Investments Commission Chair David Knott expressed principles based accounting would reduce the likelihood of manipulations of the rules as it may present the accounting reporting more precisely in showing company's actual performance (Shortridge and Myring, 2004). Schipper (2003) asserts that standard setters use principles accounting with the purpose of create rules for the users of financial reporting. It is agreed by Nelson (2003) and suggests that rules can increase the accuracy of company actual performance. It has been argued that principles-based standards uncertain to achieve those characteristics despite the standard do improve comparability (Alexander and Jermakowicz, 2006). This may lead to interrogative on the idea of principles-based is an essential useful in achieving accounting objectives.

### **What problems do standards setters have in promulgating standards that are ' principles-based'?**

Although the suggestion of principles-based standards are the ideal kind of standards, the ICAS (2007) expressed the misperception of ' we can't get there' and so standard setters take part in moving towards rules-based standards instead of embracing principles-based standards. Members of ICAS conducted a survey in 2011 showed that 72% believed that International Financial Reporting Standards were over rules controlled and 67% believed that IFRS were more weighted to rules than they were five years ago (ICAS, 2007). It was found that there are several major issues that standard setters



need to consider in promulgating principles-based standards. There will be a problem when standard setters recognize that principles-based standards are unlikely to meet the objectives of accounting standards. It has been argued that some standard setter may think standards are only promulgated as they will meet the objectives and assume that there would not be a problem, thus required no answer to the problem. SEC (2003) contends that “ it is...precisely the role of the standard setter to define the class of transactions included within the economic arrangement and then to establish the appropriate accounting for that class of transaction. While not everyone will agree with the standard setter’s conclusions, making the determination of the underlying economics of an agreement and the appropriate accounting for that arrangement are integral to the standard setter’s role” (SEC, 2003). The problems arise when standards setters consider the problematic task of adopting the sufficient amount of detailed guidance to achieve sufficient comparability and consistency in financial statements (Shortridge and Myring, 2004). Observing that FASB follows the asset and liability approach combined with fair value, as they overlook the combination of this concept with principle-based accounting will cause inconsistent. It is due to the fact that fair values involve rules in order to give sufficient appropriate guidance for management judgement and encourage manipulation, thus it is not easy to be assured by auditors (Benston, Bromwich and Wagenhofer, 2006). It seems like principles-based standards would likely degenerate into providing rules-based standards. The dismissal of true and fair override required companies and auditors to not follow the standard or rule if its application would results not to report a true and fair

view in the financial statements of the company. As a result, there will be a problem if companies and auditors do not rely on standard setters to avoid the problem of standards that will not always meet the objectives. The SEC (2003) Report indicates that principles-based accounting shows 'economic arrangements in a way that omits nothing of relevance to investors, creditors and other users, and can specify and effectively deal with how these should be accounted for', but the past rules-based standards suggests that it is an 'impossible dream' (Benston, Bromwich and Wagenhofer, 2006). In other words, new rules will be recognized when companies and auditors pursue guidance to explain but not take into account by standard setters. Therefore, it will give opportunistic managers to present misrepresentative financial statements as Weil (2002) asserts, managers would continue to say to auditors, 'show me where it says I can't'. In other words, the move away from checklist mentality will required a behavioural change (Bennett, Bradbury and Prangnell, 2006). Another issue standard setters confront is dealing with greater volatility in net income when different accounting standards may require changes accounting treatment in certain circumstances. It has been argues that if the implementation of principles-based indicates no scope and exceptions that are meant to smooth income, there would be increased volatility in financial reporting (Schipper, 2003).. Consequently, it would be a dilemma for financial statement users in predicting their future performance of using historical financial results, which reflect a fundamental judgement for investment decision making (Maines, 2007). As a result of the accounting treatment changes, the underlying economics instability would not have changed. Dissatisfaction with

principles-based standards arise as they removes alternatives accounting treatment to smooth income, however some preparers prefer accounting treatments that stabilize the economic instabilities (Schipper, 2003).

## **Conclusions**

The paper has considered why accounting and financial reporting should be regulated and the argument amongst regulators, standard setters and accounting academics corresponding on accounting standard should be principles-based standards. Most of the criticisms on rules-based standards over principles and expressed the standard has over generated detailed rules and guidance, as well as bright-line specifications in the standards, resulting in less informative and misleading financial statements. However, it is not saying that principles-based standards is always better than a rules-based standards, or that concentration on principles will always lead to less complex rules. The paper has deliberated that despite there is considerable support for the idea that a financial reporting system should be based upon principles-based standards, there is an apparent difficulty in promulgating such standards on agreeing that is the ideal standard. The major concern is that either excessive guidance in the form of bright-line tests or inadequate guidance can affect the usefulness of financial statements to users. The SEC expressed the concern that rules-based standards are likely to results low reporting quality as the standard give emphasize to form over substance. On the other hand, principles-based standards insufficient to achieve comparability and consistency as it required changes accounting treatment in certain circumstances. Niemeier (2008) believes that the lack of

requirement causes principles-based standards “ not appropriate for use in a regulatory context. By design, they are of limited enforceability.” The conclusion of the paper is that it looks like principles-based standards is more effective and useful than rules-based standards, however, it is undeniable different accounting standards will lead to different accounting outcomes.