

# Advantages and disadvantages of making accounting rules accounting essay



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Financial reporting is part of financial accounting which is the activity involved with “ classifying, measuring and recording the economic transactions of an entity in accordance with established principles, legal requirements and accounting standards” (Collis & Hussey, 2007). Financial reporting provides information about both the financial performance and position of an entity, and is involved in the communication of financial statements to external users. The process of financial reporting is monitored by a regulatory framework that ensures all statements are prepared according to rules prescribed by said framework (Collis & Hussey, 2007). Over time, countries have developed their own regulatory frameworks leading to differences in local accounting standards. This is known as ‘ Generally Accepted Accounting Principles’, GAAP (UK GAAP, US GAAP etc.). GAAP provides a set of guidelines and rules, which form the basis in the preparation of financial statements. Accounting standards are based on the conceptual framework which is a set of concepts and principles aimed at assisting and guiding preparers and standard setters of financial statements (Collis & Hussey, 2007). These accounting standards are either rules-based or principles-based. Financial statements are developed accordingly within the legal and professional framework of an individual country.

The regulatory framework in the UK is known as the UK GAAP and is primarily a combination of three sources of authority: Company law (mainly Companies Act 1985), the stock exchange rules for listed companies on the FSA and the accounting standards – ASB and IASB where necessary (Collis & Hussey, 2007). UK GAAP was based solely on company law, which provided a broad framework. However, the regulatory burden resulted in incorporation

of legal directives from the EU. These are included in the Company Act 1985 which lays down the requirements and format of the financial information that must be disclosed by all private and public companies. Regulation is also comprised with accounting guidelines which enables maximum level of up-to-date data and precision within the financial statements.

There are at least two reasons why a regulatory framework is needed both within a country and internationally. The first reason is that of irregular information. Let's assume that the managers of a firm are responsible for preparing financial statements. These managers will have access to information regarding the firm's activities while other members will not. Managers could therefore exploit their position within the firm to pursue their own goals at the expense of others. Secondly, for financial reporting to be relevant and reliable and thus, meeting the needs of shareholders and other users, the need of a regulatory framework is essential. In most cases, financial statements are the only source of information regarding the performance of a company. This is where regulatory framework ensures that the statements reflect valid and up-to-date information.

Since the time of the accounting scandals at Enron and Anglo Irish Bank for faulty statements and hidden loans, there has been pressure on the regulatory framework to modify their standards. The fact that companies and stakeholders might be deceived by fictitious financial statements is another factor which gives more value to the stress on modification on framework.

Current way of accounting has been under a great deal of criticism and there has been much debate on whether principle-based accounting would be

more efficient than the popular rules-based accounting – especially in response to accounting scandals such as Enron and WorldCom.

Rules-based accounting consists of a set of detailed rules that must be followed when preparing financial statements. Many participants (preparers, auditors and regulators) favour the prospect of using rules-based standards, because in the absence of rules, if the financial statements prepared by these participants were incorrect they could be brought to court due to their misjudgements. “ Rules-based standards provide detailed guidance and clarification and precise answers to questions”, (ICAS, 2006, p. 9) consequently increasing accuracy and reducing the ambiguity that can trigger aggressive reporting decisions by management. A rule is defined as “ a means of establishing an unambiguous decision-making method”, (ICAS, 2006, p. 9) therefore, rules-based standards provide greater comparability and consistency. Making accounting rules by law is advantageous since it adds greater recognition of individual national interests concerning accounting standards as opposed to the international interests of the International Accounting Standards Board (IASB). Taking the example of Germany, it applies the HGB (Handelsgesetzbuch), the German Law of Commerce, which is focused more on protection of capital lenders, as opposed to the focus of the International Financial Reporting Standards (IFRS) on investor information. Rules-based standards are authoritative and enforceable. As a result, these qualities represent the strictness of this approach and hence, the possibility of lawsuits is diminished.

Rules-based accounting certainly brings strong advantages to financial reporting but it can also be source of significant disadvantages. The belief is <https://assignbuster.com/advantages-and-disadvantages-of-making-accounting-rules-accounting-essay/>

that this type of accounting adds unnecessary complexity, due to the fact that rules often become very detailed, with standards approaching hundreds of pages (ICAS, 2006). It also encourages financial engineering and does not necessarily lead to a 'true and fair view' or a 'fair presentation'. Bratton (Bratton, 2003) further points out "that rules sometimes fail to capture the particularities of the individual cases". Another negative aspect of rules is that in the event of 'gaps' it does not provide enough guidance on how to proceed with these.

In the absence of specific guidance, management of a firm may randomly choose between several even opposing accounting policies (Elliot & Elliot, 2009).

The IASB is an independent accounting standard-setting body, based in London. The IASB began functioning in 2001, when it succeeded the International Accounting Standards Committee (IASC). It is funded by contributions from major accounting firms, private financial institutions, industrial companies, central and development banks, and other international and professional organizations throughout the world (IFRS, 2010). It consists of 14 members from nine countries, including the United States. More than 1200 companies in 100 countries have adopted these standards. International Financial Reporting Standards (IFRS) is a set of accounting standards, developed by the International Accounting Standards Board (IASB), and is becoming the global standard for the preparation of public company financial statements (IFRS, 2010). This has been an effect of globalisation as companies have become multinational and by adapting the same principle standards, they will be able to compare and compete equally

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on capital markets. Principles-based standards, such as IFRS, are used as a conceptual basis for accountants. A simple set of key objectives are set out to ensure good reporting. The fundamental advantage of principles-based accounting is that its broad guidelines can be practical for a variety of circumstances. Strict requirements can sometimes force managers to manipulate the statements to fit what is compulsory.

Companies interested in being placed on the stock exchange in two different countries are supposed to prepare accounts pertinent to GAAP. This method can be very time consuming and immensely costly to prepare two or more sets of financial statements. By adopting IFRS only one set of statements will be prepared and is acceptable worldwide. The Enron debacle is a demonstration of the need for a principles-based definition of control. Enron did not consolidate hundreds of off-balance sheet entities and therefore failed to recognize the associated liabilities, “ The irony is that even though Enron violated the core principles of financial reporting, the financial engineering resulted in compliance with the rules” (AICPA Professor/Practitioner Case Program, 2004, p. 2).

No matter what accounting method is used, it must always have to provide relevant and reliable information. Many issues and discussions have now pushed accountants towards principle-based accounting, but it is recognized that the method needs to be modified to make it more effective and efficient. It is different from the underlying “ box-ticking” approach common in rules-based accounting standards (Shortridge & Myring, 2006). Thus, providing broad and modified guidelines may develop representational authenticity of financial statements. A principal-based system also results in <https://assignbuster.com/advantages-and-disadvantages-of-making-accounting-rules-accounting-essay/>

simpler standards, as principles are easier to grasp and apply to a vast range of transactions. “ Principles-based accounting standards based on a clear hierarchy of overarching concepts will provide a comprehensive basis for the preparation of financial statements that has the flexibility to deal with new and different situations” (ICAS, 2006, p. 3). They also require less maintenance. The use of principal-based accounting standards may also provide accounting statements that reflect a company’s actual performance since an increase in the application of said standards would reduce manipulation of the rules (Nationwide News, 2002).

Finally, principles (IASB standards) have their potential drawbacks as well. There can be a lack of accurate guidelines that could also create inconsistencies in the relevance of standards amongst organizations. An example may be the US GAAP, which is principles based, but the rules have grown over time due to the demands of preparers and auditors for implementation guidance and consistency. The problem with principles-based standards is that lack of guidelines can produce unreliable and inconsistent information that makes it difficult to compare one organization to another (Investopedia, 2010). The disadvantage associated with principles is that they are susceptible to abuse by, in some cases, allowing management to choose the appropriate accounting treatments that best suit its interests (Bratton, 2003). ) Additionally, the vagueness of principles makes them difficult to enforce and thus creates uncertainty.

In conclusion, this essay has highlighted the fact that both accounting rules by law and IASB standards have their advantages and disadvantages and that financial reporting is influenced by many different factors such as <https://assignbuster.com/advantages-and-disadvantages-of-making-accounting-rules-accounting-essay/>

regulation. The key fact is that whichever you do select, one still has to make sure that the financial statements are produced ethically and provide a true and fair view of the company's financial position, since that is after all, what financial statements are about. The inclination seems to be towards IABS standards; nevertheless the convergence is a long process which will certainly take its time.

In light of these findings, it can be said that the more uniform financial reporting is, the higher the possibilities to compare between firms of different industries and therefore leading to higher confidence in financial statements which result in lower transaction costs and thus lowering financing costs for companies.