

Rules based versus principles based accounting research paper examples

[Experience](#), [Belief](#)



Introduction

The quality of accounting standards influences the efficiency in the functioning of the economy. This is because the decisions regarding the allocation of resources to different sectors are heavily reliant on understandable and credible information. The accounting profession in addition to those that produce and utilize financial statements is facing challenging and difficult practical and conceptual issues. Deep-seated differences exist between contrasting regulatory philosophies and established rational approaches. Over time, the looming question has been the degrees of detail required in setting standards for the profession. Another looming question has been whether the standards established should attempt to describe the application of a general standard in precise terms or whether it ought to be clearer on the principle. All this has fuelled the debate on the efficiency of principle-based accounting when compared to rule-based accounting (Brigham & Ehrhardt, 2011).

Discussion

Although there are many local standards setting bodies, the two main bodies that set accounting standards are the Financial Accounting Standard Body and the International Accounting Standard Body. The Financial Accounting Standard Body has concepts that govern its operation. Firstly, its unit of measure is money. Under the money measurement concept, the board underlines every recorded transaction or event is translated using money as a standard of measure. The body has other concepts that form part of the framework that is used to formulate and interpret standards.

FASB adds that among the overriding concepts of financial accounting is the relevance of accounting information to various decision makers. The implication of this is that all information is required to be reliable, relevant and comparable across entities and reporting periods. FASB holds that compromising on these requirements would allow entities to adopt and utilize reporting methods that reflect in the best way the economic realities of the entity. The downside of this is that it would render comparisons across reporting periods and between companies virtually impossible for interested investors (Porter & Norton, 2011).

Many scholars have argued that principle-based account cannot sustain its success in the long term. The justification of such arguments is the sophistication experienced in the financial markets. Presently, accounting numbers contain a degree of rounding off or estimation. This presents problems especially if the difference from the estimation changes the reported figures by more than ten percent. As such, it is impossible not to consider the impact this has on the reported profits. Although no systems can produce absolute comparability and uniformity, more emphasis is required on the principle judgments made by accountants as well as his sensitivities that surround them.

On the other hand, rules-based accounting is not very practical. Critics of the approach argue that the current system used in the United States is inaccurate in its reporting. The system is more focused on ‘checking the boxes’ than showing the underlying economic reality. As such there are many pages of interpretations and rules in lease accounting with very minimal leased assets on corporate balance sheets. The rules-based system

has also created an industry marred by structured transactions and financial engineering that is designed to dodge the established rules. A popular opinion is that creating more rules to create any loopholes results in more elaborate and grandiose way to circumvent the rules (Subramani, 2009). Both the FASB and IFRS are in agreement that disclosures are not substitutes for recognition. To this end, the popular opinion is that there exists only a single best way to account for transactions. Although the reported numbers may be different by small amounts because of the way accounting principles were applied, there should be constancy in the underlying approach. The principle-based approach emphasizes more on explaining all the judgments made in order to arrive at the reporting treatment. The implication of this is that there will be more elaborate and longer disclosures that accompany financial statements.

I believe that legal considerations influence and drive financial reporting. When working in a principle-based system, it is probable that two accountants will prepare different and yet technically correct judgments. Hence, the success of the principle-based accounting is dependent of legislators and regulators offering protection to auditors and accountants who make decisions and judgments out of good faith. This will protect the accountants and auditors from the ramifications that would present in case varied interpretations were probable over the application of one principle (Jeffrey, 2011).

Conclusion

It is evident that even with the raging debate over the efficiency of either of the approaches to accounting that both sides of the debate present valid arguments. The principle-based arguments leaves the accountants unprotected from legal suits. The level of accuracy of the reported figures where principle-based accounting is used has also been contested because of the effect of estimation. The rules-based accounting has been taunted as impractical and prone to financial engineering. The developing of new rules to close loopholes in the system only leads to newer and more elaborate ways of circumventing the system.

Even in the criticism of the flaws of either system, it is important to acknowledge that no system can be entirely flawless. This notwithstanding, the importance of an accounting system cannot be overlooked. As such, I am of the opinion that with time, the possibility of merging the two approaches should be explored. Standards are important so as to come up with universal accounting and financial reporting practices. This is important for comparisons over time and across companies. Principles should be accompanied by guidelines that establish rules in order to avoid varied interpretations that result in inconsistent application. As such, the task would be to establish the appropriate amount of guidance to incorporate with the principles.

References

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