Accounting standards setting approach: principles-based vs rules based

Rules-based accounting is generally a list of detailed rules that must be followed when preparing financial statements. Principle based standards derive from a conceptual framework that provides for broad ‘ principles’ to be adopted within standards and also requires professional and managerial judgment in relevance to particular transactions and events. US secretary Heary Paulson had once said “ We must rise above the rule based mindset that asks Is it legal?, and adopt a more principle based approach that asks Is this right?”. This essay discusses the principle based approach and rules based approach for accounting and critically examine the more appropriate standard of accounting.

According to Bennet et al (2006) the difference between rules-based and principles-based standards is not clear and is subject to a variety of interpretations. But there is a generally held outlook that the FASB’s standards are rules-based and the IASB’s standards are principles-based. The commencement for the current principles versus rules debate is sited in section 108 of the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act was a result to the failure of Enron and the blow to the capital market system that Enron induced. Sarbanes-Oxley Act of 2002 instructed SEC (The Securities and Exchange Commission) to carry out an investigation into the implementation by the United States financial reporting system of a Principles-based Accounting System. The preliminary effect of Enron was primarily that things have to change (ICAS 2006). Immediately prior to the fall down of Enron the Chairman of FASB was not sure that accounting principles or rules were achieving the required goals. Schipper (2003) points out that the U. S. rules are frequently based on principles. The standard setters use principles in order to create the rules for the preparers of financial statements. According to Nelson (2003) cited in Nobes (2005) said that a particular standard should be seen as rules-based standard. He also add that rules can increase the correctness with which standard setters communicate their requirements and can reduce the sort of vagueness that leads to forceful reporting choices by management.

According to Schipper (2003) and Nelson (2003) cited in Nobes (2005) say that rules standards has some potential advantages. Those identified by them include:

· increased comparability,

· increased verifiability for auditors and regulators

· reduced opportunities for earnings management through judgements, and

· improved communication of standard setters' intentions.

Many accountants favour the outlook of using rules-based standards, because if there are no rules then the accountants could be brought to court of law if their judgments of the financial statements were wrong. But when there are strict rules that have to be followed, then the possibility of lawsuits is reduced. Rules-based standards include important and specific rules to meet as many potential contingencies as possible. Principles-based accounting such as generally accepted accounting principles (GAAP) is used as a theoretical or conceptual basis for the accountants. A simple set of key objectives are set out to enable the companies to build a good report. The following section includes the discussion on the rules based standards and principle standards.

Professional judgment, Enforceability, Comparability, Complexity, Creative accounting and Economic reality are used as the indicators of the discussion (ICAS, 2006).

Views on professional judgement are separated into those who consider that rules strangle judgement and those who believe that rules act as a check on creative judgment. Professionals themselves prefer the defensive comfort of a rules-based system and are uncomfortable with the probable exposure from exercising judgement based on principles.

Enforceability is an argument which has been set forward to support rules-based standards. It is said that rules offer a clear statement for regulators and for those who focus on regulation. The criticism is that rules-based standards do not prevent dishonest practice. Manipulated fulfilment with rules makes auditing more complicated because mangers can justify their manipulation as fulfilment.

Comparability is a difficult notion because it covers a range of different meanings. Those supporting rules-based standards argue that they do provide comparability but in some other cases this comparability gets equated with uniformity. Those who oppose rules based standard argue that they detract from true comparability because they force dissimilar situations into similar treatments.

One of the strong arguments against rules-based standards is that they cause complexity and overload and which causes delay in the process of responding to changing situations. Supporters argue that rules-based standards respond to difficulties by setting a obvious pathway for dealing with complex dealings. According to Kivi et al. (2004) cited in ICAS (2006) if investors find it difficult to know the financial information in the financial statements this is not due to the complexity of rules-based standards but to the complexity of the business models which operating in the market.

The presence of creative accounting has been raised to indicate the limitations of rules-based standards because instances can be cited of professionals using the wording of the rules to produce a required solution. The ‘ roadmap to avoidance’ is seen as a outcome of rules-based accounting but well-written rules can reduce the opportunities for flexible explanation of principles that could lead to creative accounting with the help of earnings management. According to Benston et al (2006) this happened in the case of Enron and as a result of the misleading accounting procedures exposed in the investigations of Enron’s failure, the Sarbanes-Oxley Act of 2002 included a provision, Section 108(d).

Representing economic reality is seen as a advantageous aim of financial reporting but there are divisions of outlook. It could be argued that principles allow demonstration of the ‘ bigger picture’ but it could also be argued that in many cases the existing rules based standards have led to loyal demonstration of economic reality in a reliable approach. International Federation of Accountants (IFAC) felt that rules-based standards were too long and complex.

Other critics of rules-based standards have pointed out that rules can turn out to be ineffective and, worse yet, dysfunctional when the economic environment changes or as managers produce new transactions around them (Kershaw, 2005 cited in Benston et al (2006)).

Principle based accounting standard is better than rules based approach as:

It is simpler than rules-based standards

Supply broad guidelines that can be useful for many situations

Broad guidelines may get enhance the representational truthfulness of financial statements

Allow accountants to use professional judgments

Principles make structuring transactions in a particular manner more difficult to justify

After the debacle of Enron using rules based standards the enthusiasm of principle based standard approach emerged from different quarters. In 2002, FASB gave a report that “ in accounting standards developed under a principles-based approach, the principles reflecting the fundamental recognition, measurement and reporting requirements of the standards would continue to be developed using the conceptual framework. The main differences between accounting standards developed under a principles-based approach and existing accounting standards are (1) the principles would apply more broadly than under existing standards, thereby providing few, if any, exceptions to the principles and (2) there would be less interpretive and implementation guidance (from all sources, not just the FASB) for applying the standards”. According to SEC Chief Accountant Herdman an ideal accounting standard is one that is principle-based and requires financial reporting to replicate the economic essence and not the form of the matter. The European Commission has strongly promoted the use of strategy based on a principles-based approach to financial reporting which is designed to reflect economic reality and therefore giving a true and fair view of the financial position and performance of a company. Principle based approach will help protect the long term interests of the investors and other stakeholders and will help the director of the companies to make a professional judgement in selecting and applying the most suitable accounting policies.

Most of the sections of my essay are based on the survey reported by Mike Ng a senior accountant with Enron Credit Corporation. In 2004 he reported that evidence did not support the adoption of principle based standards but the evidence that was presented shows the problems of collecting opinions by using survey methods. The responses were sometimes fully dependent on the nature of the question asked. When asked whether companies could apply and interpret rules-based accounting standards in a way that does not properly reflect the economic substance of the transaction, 93% of respondents agreed to it. However when they were asked whether general principles would produce better results in forcing companies to report the economic substance of a transaction, 80% disagreed. Only 13% of the companies believed that principles would achieve a better result than rules. The critics of a principles-based approach argue that financial statements would likely lose their comparability and steadiness across industries and issues regarding income measurement and recognition would always remain divisive. Nobes (2005) argues that rules are based on the principles. Rules exists because the standards are based on the lack of principle because of which the rules are needed and if the principle were more appropriate than the need of rules would be less. Benston et al (2006) consider two shortcomings of the SEC proposed principles-based (objectives-based) standards. The standards are dependent on the contents of what the standards regulate. The more judgement an accounting principle requires, the more difficult it is to draw up a standard without direction. A true and fair is a necessary requirement for any type of standard that is more than ‘ principles-only’ to tackle with the inconsistencies between principles and regulation in order to sustain the main objectives of financial statement.

CONVERGENCE, COMPARABILITY, CONSISTENCY AND CULTURE: This section covers convergence, comparability, consistency and culture as four issues that infuse any debate on ‘ principles versus rules’ (ICAS 2006). Convergence, consistency and comparability all lay on different ranges of meaning. The focus on convergence has its implications for establishing adequate principles as a source for setting converged accounting standards. According to Andrew Bailey, the deputy chief accountant of SEC said that Principles based standards will only work if everyone is loyal to understand the objectives of the principle standards, rather than using the language of the standards themselves to structure around the requirement. This change will require a cultural shift. According to the Commissioner Cynthia Glassman of SEC the principles are not so broad that they fail to provide enough direction to those who prepare and audit financial statements. He said that the principles must be suitably well defined so that they can be applied in a manner that will allow a sense of comparability across companies. FASB emphasizes that a principles-based approach to standard setting would need changes in the processes and behaviours of all participants in the US financial accounting and reporting process, if adopted by them and not just by the FASB and other standard-setting bodies. Thus, in order for that principle standard approach to work, all participants must be equally committed to make the necessary changes.

The purpose of this review of is to provide background which is relevant to the work of the ICAS Principles versus Rules standard approach. The debate mainly started after the failure of Enron Credit Corporation when Sarbanes-Oxley Act section (108) cited this problem of rules based standards versus the principle based standards. The review does not provide a definitive conclusion to the question. I agree with the analysis and support the move towards principles-based standards suggested by the SEC that principle based standards are appropriate than the rules based standards. Principle based standards are simple than the rules based standards and allows professional judgement for the accountants. But Benston et al (2006) believes that the more judgement an accounting principle requires, the more difficult it is to draw up a standard without direction. According to Bennet et al(2006) rules are based on principles. Schipper (2003) and Nelson (2003) also points out the advantages of the rules based standard accounting. In ICAS (2006) it states that convergence, comparability, consistency and culture are the four issues that infuse the debate of rules based and principle based standards. SEC and FASB also agree to the four issues and state that all participants must be committed to work in the same direction. Both rules and principle based accounting standards have their own advantages and disadvantages but principle based standards are clearly more appropriate and have the backing of the boards from different countries than the rules based accounting standards.