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Principles-Based Accounting Standards

Cover Page Footnote
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Principles-Based Accounting Standards

by Frederick Gill, CPA

I. Introduction

The Enron and WorldCom accounting scandals raised an on-again, off-again academic debate over whether accounting standards should be “rules-based” or “principles-based” to the level of a controversy whose resolution—or lack thereof—will not only shape the United States financial reporting system for years to come, but will determine whether convergence of U.S. and international accounting standards is feasible in the near term.

In testimony before the Senate Committee on Banking, Housing and Urban Affairs, Securities and Exchange Commission (SEC) Chairman Harvey Pitt asserted that much of the Financial Accounting Standards Board’s (FASB) recent guidance has been “developed based on rules, and not on broad principles,” and he called for FASB standards to “evolve to become general and principle-based, instead of encyclopedic and rule-based, standards.”

The catchphrase “principles-based standards” resonated in the accounting community. In conversations at professional gatherings and in public statements by prominent accountants, it seemed that most everyone was expressing support for a change to principles-based standards.

That catchphrase apparently resonated in Congress, as well. Section 108 of the Sarbanes-Oxley Act of 2002 requires the SEC...
to "conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system"\(^3\) and to report on the results of the study "[n]ot later than one year after the date of the enactment of this Act,"\(^4\) that is, by July 2003.

Working in parallel with the SEC, the FASB has undertaken a project to consider the feasibility of adopting what it called "a principles-based approach to U.S. standard setting, similar to the approach used in developing International Accounting Standards (IAS) and accounting standards used in other developed countries, such as the United Kingdom."\(^5\)

Are international accounting standards and British accounting standards indeed based on principles while American accounting standards are based on mere rules? Should the FASB and the International Accounting Standards Board (IASB), which had been influenced heavily by the United States, emulate British accounting standards?

American accountants began debating the distinction between a "principle" and a "rule" almost as soon as principle was first used in financial accounting and reporting in 1932.\(^6\) That was when the American Institute of Certified Public Accountants (AICPA) recommended to the New York Stock Exchange that a framework of "accepted principles of accounting"\(^7\) be developed and that audit certificates (now called auditors' reports) for listed companies state that their financial statements were prepared in accordance with "accepted principles of accounting."\(^8\) The debate ensued because the "principles" upon which financial reporting was built were nothing more than rules and conventions.\(^9\) The profession finessed the issue by adopting what was the seventh definition of principle

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\(^3\) Id. at § 108(d)(1)(A), 116 Stat. at 769.

\(^4\) Id. at § 108(d)(1)(C), 116 Stat. at 769.


\(^7\) Id. at 4.

\(^8\) Id. at 5.

\(^9\) Id. at 6–9.
in the Oxford English Dictionary: "A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice."

That sleight of hand, of course, did not settle the matter, and accountants continued to revive it periodically. For example, the 1972 report of the AICPA’s Wheat committee, which recommended the replacement of the AICPA Accounting Principles Board (APB) with the FASB, observed the following:

"Accounting principles" has proven to be an extraordinarily elusive term. To the nonaccountant (as well as to many accountants) it connotes things basic and fundamental, of a sort which can be expressed in few words, relatively timeless in nature, and in no way dependent upon changing fashions in business or the evolving needs of the investment community.11

The report noted that many of the opinions of the APB and its predecessor, the Committee on Accounting Procedure, had little to do with "principles" as that word is normally understood.12

I am sure that many accountants and nonaccountants alike believe that financial reporting should rest on fundamental and timeless truths. But I think it is unlikely those truths will ever be discovered.

The FASB project has somewhat less lofty goals.13 It appears intended to deal with three issues: (1) widespread dissatisfaction with the lack of integrity in some areas of financial reporting; (2) pent-up frustration with the increasing volume and complexity of the authoritative accounting literature and the burden that it places on accounting practitioners (referred to as "standards overload"); and (3) convergence of U.S. generally accepted accounting principles (GAAP) with international accounting standards.14

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12 Id. at 7.

13 As of the date of this writing, little information has been made public about the SEC project.

14 See generally FASB Proposal, supra note 5 (discussing recent concerns about
Those whose economic well-being is affected by the integrity of financial reporting are dissatisfied that transactions can be structured, or "engineered," to achieve a desired financial reporting effect, resulting in some cases in deception based on technicalities. Many accountants believe that the "cookbook" way in which accounting standards have been written by the FASB both facilitates and encourages such financial engineering. It facilitates financial engineering by providing a "roadmap" to achieving the desired financial-reporting result, and it encourages financial engineering by directing the accountant to comply with detailed rules instead of directing the accountant to comply with the "spirit" (which I interpret to mean the goal) of the standard.

The sense I get is that many of those who voiced support for principles-based standards think standards should contain clear, basic conclusions, which should be supplemented by explanations or implementation "guidance." The accountant's obligation would be to see that both the letter and the goal of the basic conclusion are met. Following the implementation guidance would be the suggested or typical way to meet the letter and the goal of the basic conclusion, but, depending on the circumstances, not the only, or necessarily the right, way to do that.

Some have the impression that current IASB standards, with principles (so called by the IASB) in boldface type and

15 Sir David Tweedie, Chairman of the International Accounting Standards Board (IASB), expressed similar views:

The IASB has concluded that a body of detailed guidance (sometimes referred to as bright lines) encourages a rule-book mentality of "where does it say I can't do this?" We take the view that this is counter-productive and helps those who are intent on finding ways around standards more than it helps those seeking to apply standards in a way that gives useful information. Put simply, adding the detailed guidance may obscure, rather than highlight, the underlying principle. The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard.

Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 2.3.3 (2002) (testimony of Sir David Tweedie, Chairman of the International Accounting Standards Board) [hereinafter Tweedie Testimony], http://www.senate.gov/~banking/02_02hrg/021402/tweedie.htm (on file with the North Carolina Journal of International Law and Commercial Regulation)

16 See id.
explanations and implementation guidance in normal type, work that way. Sir David Tweedie, Chairman of the IASB, gave that impression in his testimony before the United States Senate when he said, "We favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle." But the preface to the IASB standards makes clear that the explanations and implementation guidance are more than mere suggestions, since paragraphs in both typefaces have equal authority.

The guidance in international accounting standards, regarding departures from the specific requirements of those standards, is not substantially different from the guidance in Rule 203 of the AICPA Code of Professional Conduct. Both state that accountants should follow the letter of each applicable accounting standard unless in "unusual circumstances"—the AICPA uses that term—or "extremely rare circumstances"—the IASB uses that term—the effect would be misleading financial statements.

17 Id. (emphasis added).
18 International Accounting Standard No. 1 states:

Financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable interpretation of the Standing Interpretations Committee.

In extremely rare circumstances, application of a specific requirement in an International Accounting Standard might result in misleading financial statements. This will be the case only when the treatment required by the Standard is clearly inappropriate and thus a fair presentation cannot be achieved either by applying the Standard or through additional disclosure alone. Departure is not appropriate simply because another treatment would also give a fair presentation.

PRESENTATION OF FINANCIAL STATEMENTS, International Accounting Standard No. 1, para. 11–16 (Int'l Accounting Standards Bd. 1997) (emphasis added). Rule 203 of the AICPA Code of Professional Conduct states in part:

There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.

However, in the establishment of accounting principles it is difficult to anticipate all of the circumstances to which the principles might be applied. This rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading.
One broad area in which a significant difference between U.S. accounting standards and British and international accounting standards is apparent is the amount of detail that is present in accounting standards. And it is that difference in the level of detail that makes "principles-based standards" a significant convergence issue.

Judging by the sheer volume of authoritative accounting literature, United States accounting standards are the most detailed accounting standards in the world. A crude but perhaps effective way to compare the volume of U.S. accounting standards and international and British accounting standards is to place those standards next to each other and compare their thickness. The three paperback tomes of FASB original pronouncements plus the paperback version of FASB Emerging Issues Task Force consensuses measure just over seven inches thick. In comparison, International Accounting Standards and interpretations fit into just one book, two inches thick, which is smaller in format than the FASB pronouncements and printed in a larger font. And the United Kingdom's accounting standards and proposed accounting standards fit into one book, two and a half inches thick, the same format as FASB standards but printed in a larger font.

That comparison does not even convey the true extent of the difference in the volume of authoritative literature, since it does not take into account AICPA Statements of Position and Practice Bulletins, which would add about another inch and a half to the U.S. pile, or the authoritative accounting guidance interspersed throughout eleven inches of AICPA Audit and Accounting Guides. Nor does it take into account the additional accounting

In such cases, the proper accounting treatment is that which will render the financial statements not misleading.

19 AICPA Statements of Position and AICPA Audit and Accounting Guides that have been “cleared” by the FASB fall into category b of the hierarchy of sources of generally accepted accounting principles. The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles, Statement on Auditing Standards No. 69, § 411.10 (American Inst. of Certified Pub. Accountants 1992). AICPA Practice Bulletins fall into category c of that hierarchy. Id. Auditors are required to follow the accounting principles described in those pronouncements if the accounting treatment of a transaction or event is not specified by a pronouncement in a
rules for public companies set by the SEC.

The sheer volume of authoritative U.S. accounting literature is an impediment to the convergence of U.S. GAAP and IASB standards.²⁰ Because IASB standards contain less-detailed guidance than U.S. GAAP, they allow for greater latitude in interpretation by those applying the standards. One could hardly call two sets of standards that allow so much difference in interpretation “converged.” But the IASB could not produce the volume of literature that exists in the United States any time soon, assuming that it wanted to do so. Perhaps the IASB never will be able to catch up if the FASB, with its greater resources, continues to produce guidance as fast as it can. And the IASB would prefer not to issue the volume of authoritative literature that exists in the United States,²¹ as the IASB standards are translated into about 20 languages, and more detailed standards slow down the process and increase the potential for differences in translations. Also, a body of authoritative literature as complex as the U.S. literature surely would be overwhelming—at least initially—to accountants in many parts of the world, and the IASB is aiming for acceptance and implementation of its standards throughout the world.

The difference in the volume of literature also makes the FASB’s job more difficult than the IASB’s when working on joint FASB/IASB projects, because the FASB must consider amendments to a greater amount of existing literature.

II. The FASB Proposal

The FASB believes the main differences between accounting standards developed under a principles-based approach and existing standards are: (1) the principles would apply more broadly than under existing standards, thereby producing few, if

²⁰ The AICPA’s, the FASB’s, the IASB’s, and the SEC’s concept of convergence is a movement towards the highest quality standards by both the FASB and the IASB—not simply a movement towards IASB standards or U.S. GAAP or some other existing regime—until one day there will be no significant differences between U.S. GAAP and IASB standards.

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. That result in turn would increase the need to apply professional judgment consistent with the intent and spirit of the standards. The Board also asked commentators of its proposal whether to add a true-and-fair override to FASB literature.

I believe a reduction in the number of exceptions in accounting standards would be a desirable outcome of the project; however, it will be difficult to achieve. Eliminating implementation guidance, without eliminating the reasons that the implementation guidance currently is needed, would, in my view, be an undesirable outcome of the project.

A. Reducing Exceptions

Both U.S. and international accounting standards include exceptions to broad rules—I’ll call those broad rules “principles” for lack of a better term—and inconsistencies with the FASB’s and IASB’s conceptual frameworks. The current “mixed-attribute” accounting model—in which, for example, some assets are reported in the balance sheet at their historical cost while others are reported at current market values, and some liabilities are reported at historical proceeds while others are reported at their net settlement value—is not an entirely harmonious scheme, and exceptions are often needed to hold the scheme together. Many inconsistencies between the FASB’s and IASB’s standards and the respective conceptual frameworks exist because standards predate the conceptual frameworks, and the FASB has not yet fulfilled its 25 year old promise to reexamine all U.S. standards in the light of its framework. Both exceptions to principles and inconsistencies between the standards and the respective conceptual frameworks exist as a result of efforts to satisfy the practical or private concerns of the constituents to financial reporting.

Reducing exceptions and inconsistencies in U.S. GAAP would

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22 FASB Proposal, supra note 5, at 5.
23 Id. at 10.
help reduce standards overload and would aid convergence because exceptions and inconsistencies increase greatly the level of detail and complexity of U.S. GAAP. Reducing exceptions is easier said than done because of differing and strongly held views on whether the exceptions are needed to produce financial statements that meet the desired objectives of financial reporting. But it is the FASB's job to decide difficult and usually contentious accounting issues.

B. Reducing Implementation Guidance

There is a notion that people who are educated as accountants and are experienced in accountancy tend to know what the "right" accounting answer is in most situations. If only those people had the courage of their convictions, the argument goes, there would be no need for standards setters to issue such detailed accounting guidance, and financial statements would be more representationally faithful depictions of a reporting entity's financial position and results of operations.

Having fielded calls over the years from independent accountants who believe they know the right answer, but who feel a need to arm themselves with a specific reference in the authoritative literature or an opinion from the AICPA or FASB staff before disagreeing with a client, I can attest that there is an element of truth in that notion. But the matter is not that simple.

Answers to many accounting questions are not at all obvious, even to experienced accountants. And answers to many accounting questions are inherently subjective—there are no natural laws of accounting.

Thus, the reporting of similar transactions and events differently by different companies and in different industries may

25 At the request of the Financial Accounting Standards Advisory Council, the auditing firm KPMG redrafted FASB Statement No. 87, Employers' Accounting for Pensions, to illustrate what a principles-based approach might look like. In one variant, Statement No. 87 was reduced from 77 paragraphs to 53 paragraphs, primarily by removing explicit "rules-based" guidance. In another variant prepared by KPMG, Statement No. 87 was further reduced to 14 paragraphs by eliminating exceptions and making the standard more consistent with the FASB's conceptual framework. (discussing EMPLOYERS' ACCOUNTING FOR PENSIONS, Statement of Financial Accounting Standards No. 87 (Financial Accounting Standards Bd. 1985)).
be a consequence of less-detailed accounting standards.\textsuperscript{26} Convergence towards less-detailed standards poses a particularly acute risk of inconsistent application in the international environment given the natural differences in backgrounds, experiences, and perspectives of management of global companies that will be applying IAS.

Inconsistency in the application of accounting standards should be a major concern because comparability, or the lack thereof, greatly affects the usefulness of financial statements. Indeed, the desire for comparability is why accounting standards exist at all. And the efforts of accounting standards setters in recent years to achieve international convergence (and the interest in, and support of, those efforts by regulators and the investing community) attest to the continued importance of comparability.

But why, then, has British financial reporting, which is governed by a fraction of the volume of promulgated accounting standards we have in the United States, and which is far less rigid and uniform than, say, continental European financial reporting, been regarded as nearly on a par with United States financial reporting?

Comparability, of course, is not the be-all and end-all of financial reporting. Presenting information that is useful in making investment and credit decisions and that is reliable are the main objectives of financial reporting, at least as it is seen in the United States.\textsuperscript{27} Although the rigid national accounting rules of continental Europe have required reporting information that is consistent with our reliability objective, providing information that is useful to investors and creditors has hardly been an objective, remarkable as it may seem to us, of financial reporting in continental Europe. Rather, the rules that guide the preparation of European financial statements traditionally have been selected

\begin{footnotesize}
\textsuperscript{26} Practice differences stemming from contrary interpretations of the same standard might be partially (or, perhaps, more than) offset by elimination of the divergence that results from the structuring of transactions around detailed "rules" and from the numerous exceptions in current standards.

\textsuperscript{27} Unfortunately, the usefulness of information and its reliability tend to have an inverse relationship. For example, the historical cost of an asset may be more reliably determinable than that asset's current market value, but its current market value may be more useful information. It is the job of standards setters to balance those competing objectives.
\end{footnotesize}
based on their suitability to satisfy objectives such as taxation and the regulation of enterprises. Furthermore, European accounting rules traditionally have been set by politicians and civil servants, not by the people with the most expertise in financial reporting.

Accounting standards in the United Kingdom, and other English-speaking countries such as Australia and Canada, have basically the same main financial reporting objectives as ours do, and accounting standards have been set in those countries by accountants.\(^2\) Those things alone go very far in explaining why, despite being less rigid than European financial reporting, British financial reporting has been regarded as better.

The United Kingdom also has a comparatively strong enforcement mechanism; that is, strong in comparison to most non-English speaking countries, but not as strong as that of the United States. The British Accounting Standards Board's (ASB) sister body, the Financial Reporting Review Panel,\(^2\) investigates complaints about apparent departures from the accounting requirements of the Companies Act of 1985, including applicable accounting standards. If a company's financial statements are defective, the Panel seeks a voluntary restatement. And if a voluntary restatement is not obtained, the Panel is empowered to seek an order from the court to remedy the financial statements.

But the fact that British financial reporting is regarded highly does not mean that it is as good as ours. Despite the decline in

\(^{28}\) British law, in particular the Companies Act of 1985, as amended by the Companies Act of 1987, contains accounting requirements and suggests answers to accounting questions. Those accounting requirements are, in large part, requirements of European Union Directives. However, one of those legal accounting requirements – the true and fair override contained in Sections 226 and 227 of the Act, as interpreted by British courts – effectively creates a precedence of accounting standards set by the Accounting Standards Board, the British equivalent of the FASB, over legal accounting requirements other than the true and fair override itself. See Arden, Mary, Q.C., *Accounting Standards Board: The True and Fair Requirement* (appendix to *Foreword to Accounting Standards*, Accounting Standards Board, London, 1993, at 13), http://www.asb.org.uk/publications/content/176.pdf.

\(^{29}\) The Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP) are both subsidiaries of the Financial Reporting Council (FRC). The whole organization is supported and funded jointly by the British government, the British accounting profession, and the London Stock Exchange, together with the British banking and investment community. Although both the ASB and FRRP are subsidiaries of the FRC, the ASB and FRRP are each independent in exercising their respective functions.
confidence in the U.S. financial markets as a result of the scandals of the past year, there is more confidence in our financial markets than in any of the other market systems in the world.\textsuperscript{30}

Perhaps the main concern among American accountants about adopting less detailed accounting standards is the potential for SEC enforcement actions and litigation. The FASB acknowledged that concern in its proposal, as follows:

Preparers and auditors would need to apply professional judgment in more circumstances, while the SEC, investors, creditors, and other users of financial information must accept the consequences of applying professional judgment, including some divergence in practice. Concerns about SEC enforcement actions and related litigation matters are significant, potentially affecting the extent to which preparers and auditors would be willing to apply professional judgment in more circumstances.\textsuperscript{31}

It is hard to imagine that the SEC will stop having views on how transactions should be accounted for, or that it will be willing to accept the consequences of applying professional judgment when that results in an accounting treatment of a particular transaction that differs from the SEC view. Even if the SEC said it was willing to accept more discretion in the selection of accounting treatments, there would be no assurance that as SEC personnel changes, the SEC’s approach would not change.

Those issues are troubling, because if the SEC did not permit accountants more discretion in the application of accounting standards, less-detailed accounting standards might lead to more restatements of financial statements. That would further deteriorate confidence in the financial reporting system, and likely would lead to more litigation.

Then again, less-detailed accounting standards might not lead to more restatements of financial statements even if the SEC did not permit accountants more discretion in the application of accounting standards.

For a long time, a notion has existed among standards-setters


\textsuperscript{31} FASB Proposal, \textit{supra} note 5, at 9.
that if you draw a bright line in the middle of a room and tell people not to cross it or else something bad will happen to them, people will walk confidently right up to that line. But if you tell people there is an invisible line somewhere near the middle of the room and if they cross it something bad will happen to them, people will tend to stand back from the middle of the room for fear of stepping on a line they don’t see. Perhaps that is exactly the response the SEC is hoping for. Some tend to think that is what happens in the U.K., but we don’t know if that is the case—especially in light of the complaints-driven enforcement of accounting standards in the U.K. But if the SEC’s active enforcement of accounting standards did produce that response in the United States, would the result be better financial reporting? Or, given the severity of the penalty for crossing the line in our litigious society, would it be excessively conservative financial reporting, favoring some users of financial statements and harming others?

Litigation will occur regardless of whether there are more restatements. It seems that whenever a company runs into financial difficulty in the United States, the auditors are sued. And with the benefit of hindsight, any decision they made is subject to challenge.

Preparers of financial statements and auditors have a legitimate need to protect themselves against litigation. Although following the letter of an accounting standard does not provide absolute protection to preparers of financial statements or to auditors, it is almost the only protection they have. The quality of financial reporting would be served poorly by standards that unnecessarily expose preparers and auditors to legal liability for informed accounting decisions made in good faith.

It is also not apparent to me just how the FASB could simply withdraw detailed guidance that it has already issued. Would all copies of that guidance be destroyed? If not, would accountants stop taking comfort in that guidance? Would the courts not hold that those were the right, or at least the preferred, interpretations of

the FASB’s pronouncements? Would the AICPA or some other organization not provide detailed implementation guidance if preparers and auditors demand it?

The only way I can see a reduction in the amount of detailed guidance being feasible is if the FASB replaces basic “principles” that require lots of interpretive guidance with different, more straightforward principles. For example, the Board could replace FASB Statement No. 13 on accounting for leases, and more than a score of interpretive pronouncements, with a standard that says capitalize all leases at their fair value. (The Board could also change its definition of fair value from one that makes sense only to highly indoctrinated accountants to one that just makes sense.) For another example, the Board could replace FASB Statement No. 109 on accounting for income taxes, and its many interpretive pronouncements, with a standard that says you have a liability for income taxes when you have taxable income and in the amount shown on your tax return. Or the FASB could replace the entire mixed-attribute model with a fair-value model. But that way of achieving a reduction in the amount of detailed guidance in accounting standards is not about adopting principles-based standards—it is about changing the principles.

III. Conclusion

Most, if not all, of the accounting standards issued in the United States through 1973 by the Accounting Principles Board and the Committee on Accounting Procedure were what could be called principles-based, as the FASB is defining that term. A crisis of confidence in corporate financial reporting in the 1960s and early 1970s, resulting in part from the perceived inadequacy of those standards, led to the Wheat Committee recommendation to replace the APB with the FASB. Today, the FASB and the SEC are under intense pressure to once again make sweeping changes.

I am tempted to think that the calls for principles-based standards are manifestations of nostalgia for a time that, through the filter of memory, seems simpler. But the concerns driving the debate on this issue are real. Accounting standards have become incredibly complex, with only small groups of specialists thoroughly understanding the accounting for common transactions. (At least those of us who do not belong to those
groups—"secret societies" as they have come to be called in accounting circles—think those specialists understand the accounting well.) Transactions have been structured to misinform. Independent accountants have been reluctant to challenge their clients. And the highly developed state of U.S. GAAP does make international convergence difficult in the near term. Something needs to be done.

But principles-based standards are not the "cure" for those problems. The FASB's project provides a framework for possibly taking some measures to mitigate them. Other measures, such as revisiting broken principles, need to be addressed as part of the FASB's ongoing work, preferably carried out in joint projects with the IASB.