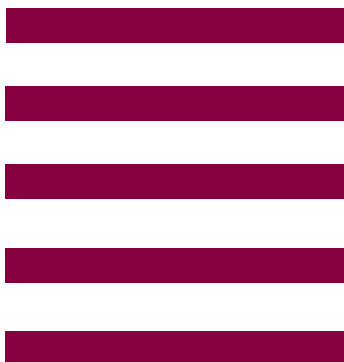




Principles-Based or Rules-Based Accounting Standards?

A Question of Judgement



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**PRINCIPLES-BASED OR RULES-BASED
ACCOUNTING STANDARDS?
A QUESTION OF JUDGEMENT**

**A REVIEW OF THE PROFESSIONAL, ACADEMIC AND
REGULATORY LITERATURE**

With contributions from

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Alex Arthur and Pauline Weetman are members of the ICAS Principles versus Rules Working Group.

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EXECUTIVE SUMMARY

The remit of this literature review is to provide a background search of relevant material in support of a working party of The Institute of Chartered Accountants of Scotland in seeking to move forward the ‘principles or rules’ debate over the future development of accounting standards.

This review presents a selection of the voluminous amount of all that has been said and written over the years about the nature of accounting principles and the support needed to make those principles operational. The selection has focused primarily on explaining how the debate developed in the immediate aftermath of Enron and WorldCom, showing the position taken by key players in the moves towards restoring confidence in capital markets in the process of establishing acceptance of International Financial Reporting Standards. There is also a brief overview of previous endeavours in the accounting profession and in academic studies to identify the principles underlying accounting practice. One limitation of a search of this type is that it can only report on material available in the public domain. This does not necessarily reflect the dynamics of private interactions between regulators and other actors. Another limitation is the impossibility of providing total coverage of the volumes of thought available.

The contrast between principles and rules came to prominence because it was highlighted in the Sarbanes-Oxley Act of 2002. Section 1 sets the debate in context by quoting the relevant section of the Act and outlining the steps taken in the US, EU, UK and Australia to assert principles-based approaches to developing accounting standards in the immediate aftermath of Enron and WorldCom.

Following the failure of Enron, the initial reaction of governments and regulatory bodies across a range of countries having significant capital markets tended to be either to call for some form of review or to adapt an existing review process in order to confirm that a principles-based

approach to accounting was already in place, albeit perhaps submersed under details of rules in some instances.

Section 2 reviews the literature which questions rules-based standards and shows the wide range of perspectives from which rules are criticised on the one hand and supported on the other, often under the same headings.

In the debate on accounting standards that followed the failure of Enron, opinions were divided on the relative merits and demerits of rules-based accounting standards. The arguments were presented from a range of perspectives, including the freedom to exercise professional judgement, enforceability, comparability, complexity, prevention of creative accounting and the representation of economic reality. From each perspective there are arguments for and against rules. There is no dissent from the position that any rules that exist should be based on a defined set of principles but there is no agreement on the extent to which professionals should be given scope to exercise judgement on the application of principles. The variation in opinions lies in the extent to which guidance is required from standard-setters and other regulators to ensure comparability, consistency and enforceability.

Section 3 traces the steps taken in the US, in response to Enron and the Sarbanes-Oxley Act, to shape a framework for principles-based standards. It shows how the initial enthusiasm from the Securities and Exchange Commission (SEC) appeared to be reined back in the light of concern as to the potential problems of allowing excessive judgement. The proposals from the Financial Accounting Standards Board (FASB) are also outlined.

The initial reaction in the US was to take the view that if rules-based accounting standards allowed the failure of Enron to develop undetected then rules-based accounting standards should not continue. The line of thinking continued with the proposition that principles-based standards were

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the opposite of rules-based standards and therefore principles-based standards would address any problems created by rules-based standards. This 'anti-rules' line of argument, which led initially to unrestricted enthusiasm for principles-based standards, then began to develop a counter-argument that some of the rules were probably useful and therefore rules would continue to be required as a means of circumscribing judgements based on principles. Calling the rules 'guidance' might be more acceptable as indicative of the new thinking. Particularising the principles in the form of 'objectives' could also limit the bounds of judgement in any one area of standard setting. There was also some political competition between standard-setters and regulators over who should define the objectives and guidance.

Section 4 considers the comments that have emerged on the type of accounting profession needed to implement a principles-based accounting system and reviews some of the research into whether the current members of the accounting profession are likely to be suited to a principles-based approach dependent on exercise of judgement. Questions of judgement, such as the ability to exercise judgement and the power of regulators to control judgement, recur in the sources considered in Sections 1 to 3. Consequently section 4 also considers ways in which differences in personality and ethical development may be researched, with particular reference to the accounting profession.

There is a history of research, predating the failure of Enron, which uses psychological testing to establish the ability or willingness of accounting professionals to exercise judgement. Much of this work emerges from debates on judgement exercised in the audit function. Interpretation of the findings of psychological testing of this type must have regard to the context of the country of the study and its institutions, professional training and culture. The timing of the study is also important as the cycle of economic boom and recession may have an impact on the relative

willingness to make judgements rather than fall back on rules. The research points to an increasing reliance on rules as the experience of problems leads to creation of more rules, the system of education and training takes up and reinforces those rules, and the familiarity with principles-based accounting slips into increasingly distant memory.

Section 5 takes a step back in time to the 1960s – beyond the working memory of many of those currently involved most actively in developing a principles-based approach. Professor Stephen Zeff¹ has compiled collections of contemporary documents that give insight into the reaction against the principles set out by Robert Sprouse and Maurice Moonitz in Accounting Research Studies 1 and 3. Those principles, advocating current value measurements, look relatively uncontroversial today but the surrounding debate, recorded as it unfolded, gives a hint of what could happen when attempts are made to incorporate subjective values in a conceptual framework that commands international acceptance. Zeff² has also traced the processes of forging accounting principles in five countries up to 1970 and his analysis of the reasons for slow acceptance of principles leads the reader to question whether attitudes have changed perceptibly in the subsequent 35 years.

For those who would seek to re-live the intensity of the 'principles and postulates' debate of the 1960s there is no substitute for reading the various works of Professor Zeff which are listed among the references set out at the end of this document. During the 1960s, professional bodies and academics, in the US in particular, were confident that accounting theory could be developed as a quasi-scientific discipline. The reasons for the failure of this initiative were complex. One explanation lay in the failure of the US Accounting Principles Board to have sufficient political power as a standard-setting body. The

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failure of the Accounting Principles Board (APB) as an organisation was seen, probably wrongly, as equating with a failure of principles. Another explanation was that the principles debate became embroiled in a debate on the merits of current value accounting. Finally there were also somewhat futile discussions on the meaning and hierarchy of terms such as ‘postulates’, ‘axioms’, ‘objectives’, and ‘principles’.

Section 6 reviews sources on a range of themes identified as being of potential interest to the Working Group. Convergence of accounting standards is a topic for which the distinction between a rules-based approach and a principles-based approach is critical. Comparability and consistency are themes identified by many commentators but with a range of meanings. Cultural considerations may help with understanding and even justifying a range of approaches to setting and implementing principles.

Convergence, consistency and comparability are all capable of a range of meanings. An extreme view would be that they represent total uniformity where all transactions and events of similar type are reported using a single procedure in a defined manner. A broader view sees a range of treatments of transactions and events of a particular type, from which one is selected. The selected treatment is explained and justified in such a way that those seeking to make comparison understand the nature of any difference from other treatments that might be applied. The broader view can be said to achieve convergence, consistency and comparability because there is harmony across the range; the stated treatments, although different, are applied consistently in comparable circumstances; and there is full disclosure of the treatment selected. However, those who use these words tend to have their own preconception, which in some cases is close to uniformity and in other cases takes a broader view.

The evidence points to the conclusion that any attempt to enforce a system of principles-based accounting standards may encounter different levels of support or resistance in different countries because of cultural traditions.

Section 7 brings the debate from particular developments to a more general perspective by outlining ideas from philosophy and jurisprudence that may help in understanding the distinction between rules and principles.

Philosophical discussions about ‘following rules’ focus on the incoherences that arise from attempting to reduce certain disciplines to a set of rules. This thinking applies even to apparently formal disciplines such as arithmetic. No fully rule-based approach to standard-setting can succeed, either in practice or in principle. Normative principles (statements of the ‘you should’ type) can be shown to be compatible with, and even required by, rational discourse. Jurisprudential writing suggests a useful distinction: on the one hand there are rules and rules-based systems and on the other hand there are principles-based systems that cannot be reduced to rules.

Section 8 summarises the views brought out in sections 1 to 7.

The literature review concludes that the ‘principles versus rules’ debate may well evolve into a question of ‘who makes the judgement?’. The evidence presented in sections 1 to 7 points to widespread endorsement of a focus on principles, with some questioning of how the ideal set of principles is determined. The conditions attached to support for principles are expressed in different ways such as a need for ‘guidance’ or ‘interpretation’. Some of these conditions are a thinly disguised attempt by interested parties to retain or impose control over the accounting agenda. Others are expressions of concern over the willingness and ability of practitioners to exercise good judgement within the greater freedom of principles-based standards. There is



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a risk of the debate on principles returning to the inconclusive debates of the 1960s because those involved in the debate do not recognise, or do not acknowledge, the spectrum of views that may exist within a framework aimed at convergence, consistency and comparability. It is also important to understand that principles in accounting will inevitably involve judgements based on society's views of acceptable conduct.

ABBREVIATIONS AND STYLE OF REFERENCING

Abbreviations

This report refers to the views of many organisations. The full name is given at the first use of the relevant abbreviation. All are summarised here for convenience.

CLERP	Corporate Law Economic Reform Program (Australia).
DTI	Department of Trade and Industry (UK government department responsible for company law).
EC	European Commission.
ECOFIN	The Economic and Financial Affairs Council, part of the Council of the European Union.
FASB	Financial Accounting Standards Board (United States of America).
FEE	Fédération des Experts Comptables Européens.
IAS	International Accounting Standards (issued by the former International Accounting Standards Committee and now part of the IFRS of the International Accounting Standards Board).
IASB	International Accounting Standards Board (setting IFRS from 2001).
IASC	International Accounting Standards Committee (superseded by IASB in 2001).
IFAC	International Federation of Accountants.
IFRS	International Financial Reporting Standards of the IASB, comprising standards issued under IFRS heading and standards issued under IAS heading by the previous IASC.
IOSCO	International Organisation of Securities Commissions.
ISA	International Standards on Auditing.
SEC	Securities and Exchange Commission (United States of America).

Style of referencing

The source material is of two types. The review has drawn on speeches, official texts and authoritative reports to give a flavour of the contemporary debate. These sources are referenced by use of endnotes to avoid disrupting the flow of the text. The endnotes in turn lead to full details in the list of references set out at the end of the report. The review has also drawn on the academic literature to give a wider perspective of opinion and to provide some evidence from research. Generally these sources are referenced by using the academic convention of including the author's name and publication date in the text, with full citation in the list of references. Where the academic style of referencing would impede the flow of a sentence, endnotes are used. The alphabetical list of references at the end of the report provides details of all source materials studied.

SECTION ONE - INTRODUCTION

The remit of this literature review is to provide a background search of relevant material in support of a working party of The Institute of Chartered Accountants of Scotland in seeking to move forward the ‘principles or rules’ debate over the future development of accounting standards.

The formal instigation for the current ‘principles versus rules’ debate is located in section 108 of the Sarbanes-Oxley Act of 2002 (see section 1.1 below).³ The Sarbanes-Oxley Act was a reaction to the failure of Enron⁴ and the shock to the capital market system that Enron induced world-wide.

This literature review focuses on the Enron-induced debate surrounding the setting and enforcement of accounting standards but it is important that any conclusions relating to the accounting debate take cognisance of the wider context of a major crisis of confidence in the capital markets and the professionalism and integrity of all participants. A limitation of any literature review is that it relies on information that is available in the public domain. There will have been many interactions between parties that are not documented.

An analogy for the complexity of the situation created by the crisis of confidence following the failure of Enron is to imagine the case of a football league where it has been discovered at the end of a season of games that each game has been noted in the official record as a no-goal draw. Spectators, players and match officials all think that they have seen the ball enter the net but no-one can recall the precise details. There are rumours of the offside rule being breached. None of the participants had checked the record at the time of each game. The official score-keeper is not available to answer questions. In the meantime the winners’ medals and prize money have vanished without trace. The teams felt cheated. Those who placed bets on the scores now feel cheated. The initial reaction is ‘how could no-one have noticed at the time?’ followed by ‘who was to blame?’. An ensuing

official enquiry has found that everyone carries a share of the responsibility for destroying the reputation of the game of football. One strand of the enquiry was to ask ‘how do we know that a goal has been scored and how is that score recorded with confidence?’. That is an important question but it is not the total answer to restoring confidence in the quality of football as a game. The enquiry has been made more complex by the complex interactions between the key participants in the structure and organisation of the football league. Each party wants to blame the others for the failings and to assert its own position for future control.

This section continues with a brief description of the regulatory bodies in the US, the European Commission, the UK and Australia, to provide a context for later chapters that comment on how regulators at national and pan-national levels reacted to Enron. Section 2 reviews the evidence that questions the existing rules-based accounting standards. Section 3 outlines the actions taken by various parties to develop a principles-based approach to standard setting and also points to evidence on the moves of various parties to position themselves for greater control of a principles-based approach to setting standards in future. It considers the concerns of regulators as to the safeguards required when principles-based accounting standards allow greater scope for the exercise of judgement. Section 4 draws on writings that reflect on the changes required in the accounting profession to apply principles-based accounting standards and that analyse the kinds of qualities and skills needed to give greater confidence in dealing with matters of judgement. Section 5 draws back from the current debate to present a wider perspective of the historical debate on the nature of principles-based accounting measurement and disclosure. Section 6 comments on the debate on convergence, distinguishing comparability from consistency and pointing to the challenges in attempting to converge

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accounting practice while acknowledging cultural diversity. Section 7 considers a broader perspective on rules and principles, drawn from philosophy and jurisprudence.

1.1 The Sarbanes-Oxley Act of 2002

The formal initiation of the ‘principles versus rules’ debate lies in section 108 of the Sarbanes Oxley Act of 2002.

108(d) STUDY AND REPORT ON ADOPTING PRINCIPLES-BASED ACCOUNTING.

- (1) STUDY.—
 - (A) IN GENERAL.—The Commission shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system.
 - (B) STUDY TOPICS.—The study required by subparagraph (A) shall include an examination of—
 - (i) the extent to which principles-based accounting and financial reporting exists in the United States;
 - (ii) the length of time required for change from a rules-based to a principles-based financial reporting system;
 - (iii) the feasibility of and proposed methods by which a principles-based system may be implemented; and
 - (iv) a thorough economic analysis of the implementation of a principles-based system.
 - (2) REPORT.—Not later than 1 year after the date of enactment of this Act, the Commission shall submit a report on the results of the study required by paragraph (1) to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.
-

The Act required a report by the Securities and Exchange Commission within one year and, in section (B) (ii) showed a perception of a contrast between rules-based and principles-based reporting systems.

1.2 The Securities and Exchange Commission (SEC)

Even before the statement of the formal requirement to carry out the specific remit of the Sarbanes-Oxley Act of 2002, the SEC had been giving attention to the issues of principles and rules in accounting standards. This review draws on the SEC’s official response to Sarbanes-Oxley and on speeches made by the chairman, chief accountant and commissioners from 2002 onwards. All speeches are available in

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full on the SEC website. The review also refers to speeches and commentary made prior to 2002 to show that the SEC already had an agenda for influencing standard setting in the US, which it continued to develop after 2002.

The SEC's response to section 108(d) of Sarbanes-Oxley was provided in a Study issued in July 2003.⁵ The status of the Study is that of a Staff response.

*This is a report prepared by the staff of the US Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.*⁶

It might seem strange to some readers that Sarbanes-Oxley requires the Commission to conduct a Study and yet the Commission explicitly expresses no view on the Study.

The historical analysis presented in the Study contains a reminder of the relationship between the SEC and the Financial Accounting Standards Board (FASB):

*Under the securities laws, including the Act, the Commission has the responsibility to develop accounting standards to be used by public companies. Despite the fact that it has consistently looked to the private sector for assistance in this task, the SEC retains the authority to establish standards if it so chooses. The SEC's authority would allow it to overturn an FASB standard by passing a Commission rule. This authority has rarely been used.*⁷

The most significant aspect of the SEC's 2003 Study was to move the discussion from principles-based standards to 'objectives-based' or 'objectives-oriented' standards. A key feature of such objectives-based standards would be to circumscribe judgement:

*Further, if properly constructed, we believe objectives-oriented standards may require less use of judgement than either rules-based or principles-only standards and thus may serve to better facilitate consistency and compliance with the intent of the standards.*⁸

It is useful to be aware of the periods of tenure of the Chairman and the Chief Accountant because their speeches are indicative of the mood of the SEC under their leadership. Arthur Levitt served as chairman from July 1993 to February 2001. Harvey Pitt served from August 2001 to November 2002. William Donaldson served from February 2003 to June 2005. Christopher Cox was sworn in as Chairman in August 2005. In the intervening periods a Commissioner took the role of Acting Chairman.

Lynn Turner served as Chief Accountant from July 1998 to August 2001. Robert Herdman served from October 2001 and Donald Nicolaisen was appointed in August 2003, departing in October 2005.

The speeches of Harvey Pitt and Robert Herdman are therefore the most immediately relevant to the implementation of Section 108 of the Sarbanes-Oxley Act but the earlier speeches of Arthur Levitt and Lynn Turner are useful in indicating the SEC's previous thinking while those of William Donaldson and Donald Nicolaisen show the extent to which the momentum created by Sarbanes-Oxley continued after the immediate crisis faded a little.

1.3 The Financial Accounting Standards Board (FASB)

In October 2002 the FASB⁹ published a proposal for public comment on a principles-based approach to accounting standard setting that discussed how that approach might improve

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the quality and transparency of financial reporting and affect development of future standards. The proposals were also described in a FASB newsletter.¹⁰

The FASB published its response to the SEC Study in July 2004.¹¹ (The response is summarised in a short article in a FASB newsletter.¹²) The FASB asserted that the objectives-oriented approach advocated by the SEC was similar to the principles-based approach described in the FASB's proposal of 2002.¹³

The FASB agreed that the objective and underlying principles of a standard should be articulated clearly and placed prominently in FASB standards.¹⁴ It also agreed with the need for implementation guidance and warned that the amount and nature of implementation guidance would vary from standard to standard. The implementation guidance would explain or expand on the principles and objectives in the standard rather than consist of a list of rules or bright lines.¹⁵ The FASB agreed that scope exceptions should be reduced but also agreed with the SEC Study that some legacy scope exceptions might have to continue where justifiable on a cost-benefit analysis.¹⁶

Schipper (2003, pp.66-67), an academic who is also a member of the Financial Accounting Standards Board, argues that US financial reporting standards are in general based on principles, derived from the FASB's Conceptual Framework, but they also contain elements, such as scope and treatment exceptions and detailed implementation guidance, that make US GAAP appear to be rules based even if the standard is based on a recognisable principle.

1.4 European Commission (EC)

The European Commission's initial reaction to Enron is found in a 2002 report to the ECOFIN Council¹⁷, (ECOFIN, the Economic

and Financial Affairs Council, co-ordinates economic policy in the EU. It is composed of the Economics and Finance Ministers of the Member States, as well as Budget Ministers when budgetary issues are discussed). The report asserts that the Commission has taken a principles-based approach to financial reporting.

1.5 UK

In responding to Enron in the UK, the Department of Trade and Industry appointed a co-ordinating group to review the UK's arrangements for audit and accountancy regulation.¹⁸ The Group reported in January 2003. Its report was used by the DTI as a basis for various regulatory developments, particularly the strengthening of the role of the Financial Reporting Council¹⁹ and its various subsidiary Boards.

1.6 Australia

In a joint press statement on 27 June 2002, the Treasurer and the Parliamentary Secretary to the Treasurer announced a process for achieving further improvement in audit regulation and the wider corporate disclosure framework as the next phase in the Government's Corporate Law Economic Reform Program (CLERP).²⁰

The enactment of the *Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act* on 30 June 2004 includes a number of reforms to the *Corporations Act 2001* and is based on the reform proposals contained in the CLERP 9 Discussion Paper issued in 2002. The CLERP 9 Act also contains a number of reforms flowing from the Federal Government's September 2003 response to the recommendations contained in the Report of the HIH Royal Commission released in April 2003.

The Treasurer introduced the CLERP 9 Bill into Parliament on 4 December 2003. Submissions

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on the Bill from interested parties were heard by the Parliamentary Joint Committee on Corporations and Financial Services in March and May of 2004. The Bill was debated in Parliament in June 2004, passed on 25 June 2004 and proclaimed on 30 June 2004. The CLERP 9 Act came into effect on 1 July 2004, though amendments relating to reporting apply to financial years commencing on or after that date.²¹

1.7 Overview and comment

The Sarbanes-Oxley Act 2002 set a formal requirement for the US Securities and Exchange Commission to study the adoption of a principles-based approach to accounting standards. That set in train a specific reaction from the SEC and FASB but the impact of Enron was significantly more widespread. The initial reaction of governments and regulatory bodies across a range of countries having significant capital markets tended to be either to call for some form of review or to adapt an existing review process in order to confirm that a principles-based approach to accounting was already in place, albeit perhaps submersed under details of rules in some instances.

Sections 2 and 3 draw in more detail on these sources to illustrate the arguments questioning rules-based standards and the proposals for supporting or enhancing principles-based standards.

SECTION TWO - QUESTIONING RULES-BASED STANDARDS

This section focuses primarily on the debate for and against rules-based standards in the aftermath of the failure of Enron. The arguments against rules-based standards often appear to complement the arguments supporting principles-based standards, while the arguments supporting rules-based standards are often complementary to those doubting the effectiveness of principles-based standards. Consequently, and to avoid duplication, this section summarises the debates under a range of themes, giving a flavour of the range of arguments encountered within each theme. Those themes are: the facility to exercise professional judgement; the enforceability of accounting standards; the importance of comparability; concerns for complexity, overload and delay in setting and modifying standards; the potential for creative accounting; and the representation of economic reality.

However the source material also points to the impression that the ‘principles versus rules’ debate grew out of an initial reaction against the existing position as the cause of the loss of confidence following the Enron failure. This section therefore starts with evidence of the nature and intensity of the initial reaction against the existing FASB standards before moving to the detailed arguments for and against.

Several of the comments noted here are based on a survey reported by Mike Ng, a senior accountant with Encore Credit Corporation. He described in 2004 the views expressed in a survey (although the details of the survey sample were not reported).²² He concluded that the evidence did not support adoption of principles-based standards but the evidence presented in the paper illustrates the problems of collecting opinions by survey methods – the responses are sometimes dependent on the nature of the question posed. 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. 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% believed that principles would achieve a better result than rules.

2.1 A need for change

The initial reaction to Enron was primarily one of ‘things have to change’. The mood of the moment appeared to be that if the system in place had not prevented Enron then clearly the system in place had to change. The logical consequence was to conclude that as the accounting standards in place were those of the FASB then clearly the FASB had to change. The extracts provided in this section show that the desire for change was strong but at the initial stage the focus was not necessarily on opposing rules-based standards. One concern was for the time taken to issue or amend a FASB standard. Another concern was for the lack of judgement applied by those using standards, in looking to the wording rather than the spirit of an accounting standard. Both of these concerns with the existing state of affairs had been expressed before Enron failed but subsequently were incorporated into the arguments criticising rules-based standards.

The continuation of an ongoing debate is evident in the words of Robert Herdman, the Chief Accountant of the SEC. In February 2002 he appeared before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, US House of Representatives.²³ He set the scene by summarising criticisms of the FASB dating from before the Enron collapse:

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Historically, the determinations by the FASB and its predecessors generally have been regarded, by the Commission, as being responsive to the needs of investors. Lately, however, concerns have arisen that the FASB is not being as responsive as it should be. Even before the recent events, the SEC staff called upon the FASB to work with us to address concerns about timeliness, transparency, and complexity. Specifically, we asked the FASB to address the following concerns:

- *The current standard-setting process is too cumbersome and slow.*
- *Much of the recent FASB guidance is rule based and focuses on a check-the-box mentality that inhibits transparency.*
- *Much of the recent FASB guidance is too complex.*

Following the announcement of Enron's failure towards the end of 2001, the immediate reaction of Chairman Harvey Pitt was to focus on the inadequate speed of disclosure by companies:²⁴

Our current reporting and financial disclosure system has needed improvement and modernization for quite some time. Disclosures to investors are now required only quarterly or annually, and even then are issued long after the quarter or year has ended. This creates the potential for a financial "perfect storm." Information investors receive can be stale on arrival and mandated financial statements are often arcane and impenetrable.

In that speech there is no mention of 'rules' in accounting. The focus on the speed of FASB reaction continued into January 2002:²⁵

... a private-sector standard setter that has a long and critical agenda, but takes too long to address critical accounting issues and is slow to finalize the principles it does address.

Immediately prior to the collapse of Enron the Chairman was not even sure that either accounting principles or rules were achieving the desired goals. His concern seemed more about the volume of the 'accounting literature':²⁶

Fourth, we should consider whether we can meaningfully update our accounting model. We may need to reconsider whether our accounting principles provide a realistic picture of corporate performance. Our accounting literature is now so voluminous that no one person - except, perhaps, Bob Herdman - can know all of it. While rules can be useful tools in achieving our reporting goals, such as comparability and verifiability, they are not and should not be treated as ends in themselves - rather, the goal is clear, verifiable information. When rules get in the way of providing clear, reliable information to investors, then it is time to change them. We could consider, for example, whether financial disclosure would be more relevant if this picture contains more information about intangibles, and, if so, whether that information would be contained inside or outside financial statements. Of course, we would work closely with FASB in any such undertaking.

It would appear from this extract that his concern was more with changing rules than with eliminating them.

Soon after the failure of Enron, speaking in February 2002, Harvey Pitt remarked at the Winter Bench and Bar Conference of the Federal Bar Council:²⁷

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Confidence in our capital markets cannot be maintained if the public believes everything is a game to enable corporations to rely on lawyers and other professionals, who in turn rely on a literal reading of the law or governing principles. That, in my view, is a major flaw in our system that Enron has exposed. Government, or at least government acting alone, should not be expected to solve this problem. It must be solved by professionals who are faithful to their professional obligations. The notion lawyers too often adopt is that if it's technically legal, it must be ok! Helping a company fall within very literal legal prescriptions, even when doing so flies in the face of what the particular legal prescriptions were obviously intended to accomplish, endangers public confidence, and is surely ill advised.

At this point in his speech he seems to be critical of principles, at least when they are interpreted literally without exercise of judgement. But as the speech progressed, the envisioned relationship between SEC and FASB was set out:

That is why we are advocating fundamental and far-reaching changes in the Financial Accounting Standards Board. We seek to move toward a principles-based set of accounting standards. The SEC must play an active and aggressive oversight role vis-à-vis FASB. This means the SEC must have greater influence over FASB's agenda, and should be able to require FASB to address critical subjects and promulgate standards in a short time frame, rather than the years it currently takes for principles to be announced. It also means adding disclosure to explain the impact on financial reports of key accounting principles and decisions.

Even here it is not clear what he is advocating. He urges a move toward a principles-based set of accounting standards but then digresses into an intention to direct the FASB's agenda and shortening the time frame for promulgating standards. He seems more concerned with the time taken to announce principles than with the principles themselves.

These extracts from speeches by the SEC chief accountant and chairman illustrate the complexities of analysing the arguments presented in opposition to rules-based accounting standards. The rest of this section presents a sample of the arguments for and against rules-based standards under various thematic headings.

2.2 Professional judgement

2.2.1 *Against rules: they reduce the exercise of professional judgement*

Concerns have been expressed that executives challenge auditors by saying 'Show me the rule that says I cannot do this'.²⁸ Auditors may also prefer a situation where they know that, if a client challenges their view, other audit firms will give the same answer because all are applying the same rule. This reduces the risk of losing clients to alternative opinions.²⁹

The quest for bright line accounting rules has shifted the goal of professional judgement from consideration of the best accounting treatment to concern for parsing the letter of the rule.³⁰ Rules-based accounting standards lead to a "box-ticking" approach.³¹

The survey reported by Ng³² included the views that rules must be argued against but principles must be argued for, requiring a different professional attitude; and a principles-based approach would lead to more professionally-based decisions.

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Reference has already been made to the speech by Robert Herdman, the Chief Accountant of the SEC, in February 2002 when he appeared before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, US House of Representatives.³³

Much of the recent FASB guidance is rule based and focuses on a check-the-box mentality that inhibits transparency.

He then continued by contrasting judgement with the 'check the box approach' of compliance with rules and gave examples of rule-based accounting standards:

Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgements from the application of the reporting. Examples of rule-based accounting guidance include the accounting for derivatives, employee stock options, and leasing. And, of course, questions keep coming. Rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard.

He appears to give support to the exercise of judgement, although the word 'objectives' is used rather than 'principles'. This distinction of wording became clearer once the SEC Study of 2003 was issued (see section 1.2).

Research based on observing choices made by auditors³⁴ shows that subtle changes in the wording of regulations are perceived to have differences in meaning, and these differences are detected and acted upon by practitioners. The researchers provided a series of different forms of wording of the regulated definition of an extraordinary item, with each modification becoming successively more precise. The

researchers' intention was to reduce the potential for flexibility in interpretation and hence reduce "aggressive" reporting decisions. They found this to be the effect, as observed during office training sessions with experienced auditors.

However, research also brings out an opinion that rules cannot cover every situation or eliminate the need to consider economic substance. Under a principles-based approach, new transactions or events not originally contemplated could be analysed within the principles without having to revise or create a standard.³⁵

2.2.2 Supporting rules: they are what the participants want

In the view of the FASB (FASB 2002a) much of the detail and complexity in accounting standards has been demand driven, resulting from exceptions to the principles in the standard and the amount of interpretive and implementation guidance provided by the FASB.³⁶

The survey reported by Ng gives several views supporting rules-based standards.³⁷ Rules provide boundaries that help auditors to draw a line when a company's interpretation goes too far. Principles-based standards ignore the reality of the competitive pressures on preparers and auditors to present a company's results in the best possible light. A return to the principles-based approach of the US Accounting Principles Committee (APC) in the 1970s is not practicable because all participants (companies, auditors and analysts) have become accustomed to rules-based standards. When standards were more principles based they resulted in varying interpretations of financial results. Accountants and auditors would need even more knowledge to be able to determine the economic substance of a transaction.

A summary by Kivi *et al.* (2004) includes the supporting views that rules are said to be driven by demand, with bright-line rules being easy to apply, audit and enforce.³⁸

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2.3 Enforceability

The SEC, in its 2003 Study, noted a concern that principles-based standards might lead to greater difficulty in seeking remedies against ‘bad’ actors, either through enforcement or legislation. The SEC’s proposed solution involved what it described as ‘narrowly circumscribed substantive accounting objectives’ which would minimise the degrees of freedom available to achieve ‘desired’ accounting results.³⁹

A more sceptical view is that neither rules nor principles will prevent false accounting. If there is an intent to produce false financial statements then both rules and principles will be ignored.⁴⁰

2.3.1 Against rules: they do not prevent dishonest practice

In September 2004 a round table discussion was held at Baruch College, New York City⁴¹. Joseph Graziano, Managing Partner of the Accounting Principles Group, Grant Thornton, argued for a principles-based approach but noted that it would take time to achieve and would require the commitment of the financial community. Arguing for a rules-based approach, William Bratton Professor of Law, Georgetown University Law Center, noted that rules-based GAAP had not caused recent financial reporting breakdowns. He cited the GAO’s (General Accounting Office) *Catalog of Restatements*, which showed that many cases involved rules-based regimes but more involved principles-based GAAP. Bratton suggested a search for deeper causes.

The survey reported by Ng⁴² included the view that principles-based standards would require more accountability from those preparing and auditing the financial statements.

2.3.2 Supporting rules: they are authoritative and enforceable

The risk of litigation is a major concern for preparers and auditors in the US. Securities-related suits had reached an all-time high in 2001, even before Enron.⁴³

The number of requests for implementation guidance received by FASB has always been high, and their significance resulted in the formation of the Emerging Issues Task Force. If financial statements conform with accepted rules, the bases for a lawsuit are diminished.⁴⁴

Interpretation of principles-based standards would rely on good faith efforts by those involved but the evidence of Enron indicated that such good faith was lacking.⁴⁵ Kivi et al. (2004) mention the perceived problem that principles-based standards are more time-consuming to enforce. Litigation could increase even where the principles have been applied in good faith.

2.4 Comparability and consistency

Commentators in the ‘principles versus rules’ debate frequently refer to ‘comparability’. However ‘comparability’ has different meanings for different people: some think it means identical accounting treatment for all transactions of a defined class while others accept that comparability is a quality that allows users of accounting information to understand the underlying economic reality of the transaction. In this second approach the accounting treatments do not have to be identical but they must be transparent and understandable to allow the user to make the comparison. There is consistency in the approach rather than identical treatment.

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Quinn (2003) quotes O'Malley, a member of the International Accounting Standards Board (IASB):

With Americans there's this obsession with treating everything the same. But treating everyone equitably doesn't mean treating everyone the same – that is, with consistency. In the US this way of thinking inevitably adds up to more rules... So US GAAP applies judgement through trying to determine what bucket something falls into. Then you know the rule, and the rule will give the answer.

2.4.1 Against rules: they do not ensure comparability

Loss of comparability because of management and auditor discretion was one of the concerns about principles-based standards noted by the SEC in its 2003 study. However this was seen as a concern relating to 'principles-only' standards. Properly constructed objectives-oriented standards would improve comparability compared to rules-based standards because the application of an objectives-oriented standard would reflect the underlying economic substance of transactions or events.⁴⁶

The SEC argued that uniformity of accounting treatment may only result in a superficial kind of comparability if guidance is inappropriately rigid and forces unlike transactions into the same accounting treatment. Clustering of transactions on either side of a bright-line rule results in different accounting treatments being applied to arrangements that are fundamentally the same.⁴⁷ Jackson (2004) quotes a partner in a major international accountancy firm operating in South Africa who was concerned that rules-based regimes may cause rigidity within the governance process and, by implication, within the reporting system.⁴⁸

2.4.2 Supporting rules: they provide comparability

It has been suggested that in the US a principles-based standard often becomes a rules-based standard in an effort to increase comparability and consistency.⁴⁹ The survey reported by Ng included the view that rules-based standards increase comparability and consistency.⁵⁰ There are potential drawbacks to a principles-based approach to standards setting because a lack of precise guidelines could create inconsistencies in the application of standards across organisations. Asking preparers to form a judgement on a contingent liability could lead to inconsistency in determining whether liabilities were probable or only reasonably possible. The lack of bright-line standards may reduce comparability and consistency.⁵¹

2.5 Complexity, overload and delay

The FASB acknowledged, in its 2002 proposals, the limitations of rules-based standards, as expressed by others:

*Recently, many have expressed concerns about the quality and transparency of US financial accounting and reporting. A principal concern is that accounting standards, while based on the conceptual framework, have become increasingly detailed and complex. Many assert that, as a result, it is difficult for accounting professionals to stay current and that accounting standards are difficult and costly to apply. Many also assert that because much of the detail and complexity in accounting standards results from rule-driven implementation guidance, the standards allow financial and accounting engineering to structure transactions "around" the rules, thereby circumventing the intent and spirit of the standards.*⁵²

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Paterson (2003) commented on the FASB proposals:

But now we come to an apparent mystery. How is it that the UK and International Accounting Standards Boards appear to have found reliable principles on which to base their own standards, principles that have eluded FASB? After all, both bodies have themselves adopted conceptual frameworks that are largely copies of FASB's version, and claim to follow them. The answer is that they haven't. Our standards aren't really more principled than the American ones, they are simply less detailed. And even that is changing - both the UK and IASB rulebooks have swollen very considerably in recent years, often inspired (if that is the word) by the content of the equivalent American standards.

2.5.1 Against rules: they cause complexity, overload and delay

The complexity problem is seen in the view that if rules 'engineer' an accounting solution they may get in the way of the activity to which the accounting is addressed, an example being accounting for stock options.⁵³ There is a view that principles-based standards would be simpler to understand. However it may be that simplicity is being equated to the relative length of a standard, as indicated in the following extract:

*Another advantage of a principles-based system is that it would result in simpler standards. Herz has claimed that a principles-based system would lead to standards that would be less than 12 pages long, instead of over 100 pages (BusinessWeek online, 2002). Principles would be easier to comprehend and apply to a broad range of transactions.*⁵⁴

The argument of simplicity was seen in the survey reported by Ng,⁵⁵ which also suggested that principles-based standards would be easier to understand. The survey responses included

the view that a principles-based approach would reduce the volume of GAAP that accountants would be required to keep up with.

Jackson (2004) quotes the head of a corporate consulting firm in Canada who said that a 'comply or explain' governance regime (*ie.* principles rather than rules) worked better in sectors where there was a lower degree of complexity and less public interest.⁵⁶

The critical view of the Chief Accountant of the SEC, appearing before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, US House of Representatives⁵⁷ has already been mentioned, linking complexity to a criticism of the slow process of setting standards in a rules-based system. There is support for this concern in other commentaries.⁵⁸

In July 2003, Commissioner Cynthia Glassman addressed the Exchequer Club:⁵⁹ Her criticism of the complexity of rules provides contrasting examples of what may be regarded as principles. Here the high-level concepts of 'useful information', 'full disclosure' and 'transparency' are cited as guiding principles.

Complying with the complicated maze of rules and interpretations that comprise Generally Accepted Accounting Principles seems to have become an end unto itself, rather than a means of providing useful information to investors and other end-users. Even worse, aggressive interpretation, technical compliance and gamesmanship have in too many instances replaced full disclosure and transparency as the guiding principles for financial reporting.

In this extract the Commissioner concentrates on the complexity of the existing rules, as a negative aspect. However the wording leaves the door open to creating new rules for disclosure and transparency. Criticism of rules is not necessarily to be equated with support for judgement-based principles.

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The FASB reported in its 2002 newsletter that the volume and complexity of accounting standards had led to a perception of overload.⁶⁰

The term “standards overload” is one that has been used off and on over the years by the FASB’s various constituent groups to describe their concerns about not only the volume of accounting rules and the level of complexity and detail of those rules, but also the resulting profusion of footnote disclosures and the difficulty of finding all the accounting rules on a particular subject. Those concerns surfaced once again in the responses to the 2001 Annual Financial Accounting Standards Advisory Council Survey—with respondents suggesting that the Board place a high priority (in the form of resources) on finding ways to codify and simplify the accounting literature.

2.5.2 Supporting rules: they respond to complexity

The survey by Ng (2004) included the view that rules-based standards were needed because of the complexity of the system. Jackson (2004) quotes the head of a corporate consulting firm in Canada as pointing to the financial services sector as one that operates better under a stricter rules-based regime. ‘It’s a complex business where you don’t want a lot of loopholes’.⁶¹

2.6 Creative accounting

2.6.1 Against rules: they foster creative accounting

Rules foster creative accounting by diverting judgement from economic substance to the detail of application. The most frequently cited complaint is that bright-line tests provide a ‘roadmap’ for those who intend to comply with the letter but not the spirit of rules (SEC 2003; Schipper, 2003; Shortridge and Myring, 2004)

The use of principles-based accounting standards may provide accounting statements that more accurately reflect a company’s actual performance. Shortridge and Myring (2004) cite Australian Securities and Investments Commission Chair David Knott as stating that an increase in principles-based accounting standards would reduce manipulations of the rules.⁶²

The SEC, in its 2003 Study, pointed to the problems of complex financial engineering designed to circumvent a rules-based regime.⁶³ Broad principles avoid the pitfalls associated with precise requirements that allow contracts to be written specifically to manipulate their intent. The distinction between finance leases and operating leases is a well-reported example.⁶⁴ Significant judgement remains in a rules-based system but it is shifted away from capturing the economic substance and towards selecting an applicable treatment from a complex maze of scope exceptions.

Tendency to earnings management

Nelson *et al.* (2002) reported a survey of US audit partners on their experience with attempts at earnings management by their clients. The study found that managers were more likely to attempt earnings management, by structuring transactions, when precise standards governed the transactions. Auditors are more likely to let the structuring stand when the rules are precise and the structuring is consistent with the rules. On the other hand, managers are more likely to attempt earnings management with unstructured transactions when the standards are imprecise. Auditors are more likely to accept such attempts at earnings management through unstructured transactions when the standards are imprecise. The overall impression from this paper is that if managers want to manage earnings they will find a way to do it and will use a method that fits with the type of accounting standard in question.

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Roadmap to avoidance

Deputy Chief Accountant Scott Taub, in December 2004, explained that new forms of business transaction may develop as a response to new accounting standards:⁶⁵

Let me turn now to another significant issue that impairs the quality of financial reporting. One of the major hurdles the FASB faces is that the promulgation of an accounting standard is itself often a catalyst for the development of new transactions. Indeed, in many instances, the issuance (or even expectation) of a new standard triggers an immediate search to determine techniques to structure and/or restructure transactions to avoid reporting the very information sought by the new standard. Standard setters have sometimes responded to structuring efforts by refining and expanding the standards. However, this process leads to a vicious cycle, where restructuring of contracts and the creation of innovative new financial structures lead to revisions in GAAP, which are then followed by the creation of additional financial structures. Under this scenario, the detailed rules themselves come to provide a roadmap for avoiding their intent. This problem was highlighted in the SEC staff report on principles-based accounting standards last year, and by Andy Bailey a few minutes ago, as he stressed the importance of complying with the spirit, and not just the letter of the standards.

Perhaps the best example of this relates to leases. When the FASB issued Statement 13, many lessees immediately began to restructure their leases to avoid capital lease accounting.

It is often said that an entire industry has grown up around structuring leases to obtain various results under GAAP.

Encouragement to aggressive accounting

Nelson (2003) takes a broad view of the meaning of 'rules':

I define "rules" broadly to include specific criteria, "bright line" thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidance, etc.

Nelson observes that the research literature suggests several broad conclusions about the incremental effects of additional rules on a standard's ability to communicate clearly and constrain aggressive reporting. There should be enough rules to communicate clearly but not so many rules that practitioners are overwhelmed. He suggests that increasing the extent to which the various rules in a standard are related to each other should help avoid overwhelming practitioners with complexity. He also suggests that when standards are very precise they may offer a 'safe harbour' for structuring transactions to match the rules. Strongly rules-based standards may thus encourage aggressive reporting.

2.6.2 Supporting rules: they deter creative accounting

The respondents to the survey reported by Ng (2004) largely agreed that it was possible to misrepresent the economic substance of a transaction while complying with a rules-based standard. However they largely disagreed that a principles-based standard would give better results in representing economic reality in the financial statements. Ng concluded that his evidence did not support adoption of a principles-based approach and so FASB should continue to improve on the existing rules-based standards.

Jackson (2004, p.58) quotes the Section 404 (internal control) project manager for a company based in California. The project manager said that the 'bad' side of principles-based standards was the

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variation they could produce. He saw a risk that preparers would twist or spin the presentation to emphasise what they wanted to and would hide the rest.

2.7 Economic reality

2.7.1 Principles, rather than rules, represent economic reality

Kivi *et al.* (2004) regard the presentation of economic substance as the most compelling argument in favour of principles-based standards. They also note supporting arguments that: principles-based standards are more responsive to changes in business practice and will improve transparency of reporting; and principles-based standards make it easier for the preparer and the auditor to see the 'big picture'.

2.7.2 The rules-based system has represented economic reality in many situations

Responses reported by Ng (2004) present the view that the rules-based standards have worked effectively to reflect the economic substance of a large number of transactions. Replacing rules with principles may imply that these rules did not reflect the economic substance.⁶⁶

2.8 Imperfections in the present standards

2.9.1 The demand for exceptions

FASB, in its proposals of 2002, devoted a significant proportion of the proposals to a discussion of the role and problems of exceptions in accounting standards:

Exceptions in accounting standards create situations in which the principles in the standards do not apply. Such situations often result from compromises made to balance the need for decision-useful information with the practical concerns of the Board and its

constituents. For example, some exceptions are provided to allow the accounting for transactions and events that would otherwise be accounted for under the standards to continue under other existing accounting pronouncements (scope exceptions). Other exceptions are provided to achieve a desired accounting result, for example, to limit the volatility of reported earnings that would result by applying the principles in the standards (application exceptions). Yet other exceptions are provided to mitigate the effects of transitioning to new accounting standards (transition exceptions).⁶⁷

2.9.2 Mixed attribute models

Sir David Tweedie in 2004 gave a more specific example of the 'rules versus principles' debate in a statement to the Committee on Economic and Monetary Affairs of the European Parliament, showing how the current mixed attribute model of IAS 39 causes problems:⁶⁸

In this mixed attribute model, IAS 39 allows similar financial instruments to be accounted for differently depending on management's designation or its stated or intended use of the instruments. Its use of alternative accounting methods necessitates detailed rules to limit the extent to which management can defer losses and manage earnings by the selective recognition of gains and losses and compromises our primary objective of providing principle-based accounting standards.

2.9.3 Unsuitable principles may create a need for rules

Nobes (2005) pointed to six examples of standards which, in his view, were rules-based because either they lacked principles or they were based on unsuitable principles. His six topics were (with the system of standards in parenthesis):

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- Leasing (IFRS)
- Employee benefits (IFRS)
- Financial assets (IFRS)
- Government grants (IFRS)
- Subsidiaries (US)
- Equity accounting (IFRS)

For leasing, based on the principle of transfer of substantially all risks and rewards, Nobes proposed the improvement of applying principles based on the definitions of asset and liability. For employee benefits the existing principle was protecting financial statements from volatility. Nobes proposed the improvement of using faithful representation. For financial assets the existing principle was to consider the documented intentions of the directors. Nobes regarded this as a rogue principle. He recommended the alternative of valuing all financial assets at fair value. For government grants the existing principle was matching. Nobes proposed using the definition of a liability. For subsidiaries in the US the existing principle was ownership. Nobes proposed the improvement of control and definition of an asset. For equity accounting the existing principle was that of significant influence. Nobes pointed out that this principle was not found in either of the conceptual frameworks of the FASB and IASB. He regarded this as a 'rogue principle' and preferred the associate to be accounted for like other investments in non-controlled entities.

2.9.4 *An unsuitable conceptual framework.*

Paterson (2003) was critical of the conceptual framework of the IASB and the UK Accounting Standards Board (ASB), both based on that of the FASB:

The other possible way that FASB has identified for simplifying and shortening its standards is by eliminating exceptions to their basic principles. But again this is problematic. The

reason for putting exceptions in standards is usually that the principles turn out not to have been much good in the first place - they give silly answers in certain circumstances that require to be made the subject of exceptions. This again takes us back to the problem of reliance on a flawed conceptual framework as the fount of accounting inspiration.

He does not spell out his criticism in that paper.

2.9.5 *Inconsistencies in existing standards*

Forsyth *et al.* (2005) identified inconsistencies in existing US GAAP where some standards do not appear to be based on the conceptual framework. These are executory contracts, valuation of future cash flows and stock dividends and stock splits. With executory contracts there are standards for purchase commitments that are not fully effective but there are no accounting pronouncements for supply commitments. Different approaches to future cash flows are found in different standards, such as the different debtor and creditor treatments for troubled debt restructuring (SFAS 15 and SFAS 114). There are different approaches to small stock dividends, large stock dividends and stock splits. The authors provided these examples as illustration of the need to strengthen the FASB's Conceptual Framework.

There have been suggestions that common law systems lend themselves to a principles-oriented approach to accounting while code-law is linked more naturally to rules-based accounting. Alexander and Archer (2000) questioned the validity of that distinction:⁶⁹

The proposition that Anglo Saxon Accounting (ASA) is fostered by a shared common law tradition in English-speaking countries hardly withstands the observation that the country most often bracketed with the UK and Ireland in its approach to the true and fair view (TFV) in The Netherlands (Parker and Nobes, 1994),

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a country that has a codified system of law. If it is sometimes contended that the common law tradition coupled with private sector standard setting leads to a more flexible and responsive system for accounting regulation, it is at least as easy to find counterexamples to this proposition as it is to find supporting evidence. The US, which has a common law legal system, increasingly has a very detailed and rigidly prescriptive set of financial accounting standards. This seems to have little to do with the nature of the US legal system, and a great deal to do with the litigious nature of US citizens. By contrast, Germany (like Continental Europe in general) has a codified law system, but the use made of statute law to promulgate accounting rules leaves considerable scope for flexibility. A large part of German basic accounting principles, namely the Grundsätze ordnungsmäßiger Buchführung, are not part of the codified law. Consequently, there exists in Germany a “market for interpretations” (Ordeltjeide and Pfaff, 1994), in which senior professionals and academics contribute their views in commentaries, journal articles and expert opinions. Rhenman (1973) proposed a “principle of equifinality,” according to which similar ends could be reached by disparate means. It seems to us that either flexibility or rigidity of a system of accounting rule making may be achieved under either a common law-based legal system or a codified law system. This is further evidence of the mythical nature of the belief in ASA.

2.9 Overview and comment

The need for change seems to have given a very strong drive to the calls for principles-based standards. There has been dissatisfaction with rules-based standards because they are associated with corporate failures that demonstrate inadequacies in accounting information. However

exploring in more detail the arguments for and against rules indicates that on each theme there are views for and against rules. This section has presented support and criticism under seven themes, summarised as follows:

- Views on professional judgement are divided into those who believe that rules stifle judgement and those who believe that rules act as a check on unfettered discretion. There is also a suggestion that the professionals themselves prefer the protective reassurance of a rules-based system and are uncomfortable with the potential exposure from exercising judgement based on principles.
- Enforceability is an argument put forward to support rules-based standards. It is said that rules provide a clear statement for regulators and for those subject to regulation. The counter-argument is that rules-based standards have demonstrably not prevented dishonest practice. In relation to enforceability the ‘principles versus rules’ debate is probably a distraction. Quinn (2003) quotes Whittington, a member of the IASB: ‘If people are dishonest any system is vulnerable, including a principles-based one. What is true and fair to a scoundrel? You need good ethics and a good system of corporate governance.’
- Comparability is a difficult concept because it covers a range of meanings. Those supporting rules-based standards argue that they provide comparability but in some cases this may equate comparability with uniformity. Those opposed to rules argue that they detract from true comparability because they force unlike situations into similar treatments. We return to this in section 6.2.
- One of the strong arguments against rules-based standards is that they cause complexity and overload and they delay the process

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of responding to changing circumstances. Supporters argue that rules-based standards respond to complexity by setting a clear pathway for dealing with complex transactions. There is an argument (Kivi *et al.* 2004) that if investors find it difficult to understand the financial information in the financial statements this is due not to the complexity of rules-based standards but to the complexity of the business models now operating in the market.

- The spectre of creative accounting has been raised to point to the limitations of rules-based standards because instances can be cited of professionals using the wording of the rules to create a desired solution. The 'roadmap to avoidance' is seen as a consequence of rules-based accounting but well-written rules may reduce the opportunities for flexible interpretation of principles that could lead to creative accounting via earnings management.
- Representing economic reality is seen as a desirable aim of financial reporting but again there are divisions of opinion. It could be argued that principles allow representation of the 'bigger picture' but it could also be argued that in many cases the existing rules have led to faithful representation of economic reality in a consistent manner.
- Finally this section has outlined the views of commentators who have given warnings that rules have emerged in some instances because the principles were not suited to the situations to which they were applied. Imperfections in present standards are seen in mixed attribute models, in unsuitable principles and in inconsistencies between standards. These are not failures of rules-based accounting as such – they are situations where rules have proliferated because the underlying principles had not been given adequate attention.

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This section traces the development of thinking on the meaning of ‘principles-based’ standards in the immediate aftermath of the Sarbanes-Oxley Act. The review is largely chronological, giving evidence of the initial enthusiasm which then modified into a concern to circumscribe the potential risks of permitting unfettered judgement. As the consequences of Enron receded in memory there emerged evidence of a stronger determination to retain aspects of the discipline of rules, probably re-labelled as ‘guidance’. Finally this section points to some of the initiatives taken by FASB in its move to demonstrate its principles-based approach.

3.1 Initial enthusiasm

The initial enthusiasm for principles-based standards emerged in many quarters, as this section indicates.

3.1.1 FASB

In its Proposal of 2002, the FASB did not give a precise definition of a ‘principle’ but the nature of a principle may be deduced from the description of a principles-based standard:

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. That, in turn, would increase the need to apply professional judgement consistent with the intent and spirit of the standards.⁷⁰

The FASB appeared at this point to equate principles with the contents of a conceptual framework.

The FASB document did not anticipate the ‘principles or objectives’ debate that emerged later from the SEC. The only point where an objective appeared as a potential statement of principle is seen in the illustration showing how the standards section of FASB Statement No. 34, *Capitalization of Interest Cost*, might look if developed under a principles-based approach. It begins with a statement of objectives:⁷¹

The objectives of capitalizing interest cost are:

- a. To obtain a measure of acquisition cost consistent with the present accounting model that reflects the enterprise’s total investment in the asset. Acquisition cost provides the most reliable measure of cash flow service potential at acquisition. The cash flow potential of an enterprise’s assets is significant information in assessing the future net cash flows of the enterprise. A measure of acquisition cost that includes interest cost is likely to be more useful to investors and creditors than one that does not.*
- b. To charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periods benefited.*

The Board defended its position in the detail and complexity of present-day standards:

Many factors shape the development of accounting standards. However, in the Board’s view, much of the detail and complexity in accounting standards has been demand-driven, resulting from (1) exceptions to the principles in the standards and (2) the amount of interpretive and implementation guidance provided by the FASB and others for applying the standards.⁷²

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The Board summarised the arguments in favour of a principles-based approach:

On balance, the Board believes that if other participants in the US financial accounting and reporting process make the changes required under a principles-based approach, the benefits of adopting that approach would outweigh its costs. The result would be high-quality accounting standards that improve the transparency of financial information essential to the efficient functioning of the economy. Also, because the standards will be less detailed and specific, they will be more responsive to emerging issues in the changing financial and economic environment in which many companies operate. Further, because a principles-based approach is similar to the approach used in developing IAS and accounting standards used in other developed countries, adopting such an approach could facilitate convergence as the FASB works with the IASB and other national standard setters in developing common high-quality accounting standards.⁷³

At the same time, Robert H Herz, FASB Chairman, stated,⁷⁴

The FASB is committed to improving US financial accounting standards. Many believe that moving to broader, more principles-based accounting standards such as those used in other parts of the world would facilitate better reporting in the United States. Others, however, are concerned that a principles-based approach could reduce the comparability of financial information and leave too much room for judgement by companies and auditors.

3.1.2 SEC Chairman Pitt

Chairman Harvey Pitt⁷⁵ gave an example of a commendable principles-based accounting standard:

Judge Friendly's⁷⁶ decision came at a time when — unlike the situation today — accounting standards were more often based on broad principles, and their objectives were stated unequivocally. The standard for accounting for the cost of inventories is a good example — it provides, along with other broad principles, that overhead must be included in the cost of inventories, no matter how determined. In the 49 years since that standard was promulgated exactly one interpretation has been needed, and that was way back in 1974! And I am unaware of any recent enforcement cases involving inventory accounting. These are the kind of standards we need for all accounting principles. In moving to that system, we must remain concerned about fair presentation, and there must be enough certainty to avoid unfair liability for good faith efforts to follow standards articulated more clearly.

As an aside, it is interesting to note that in the same speech the Chairman used the word 'rules' six times with approval. In each case the 'rules' in question were those of the SEC. It may therefore be difficult to change the rules-oriented culture of the SEC.

3.1.3 SEC Chief Accountant Herdman

Herdman, in his appearance before the US House of Representatives,⁷⁷ described the ideal accounting standard:

An ideal accounting standard is one that is principle-based and requires financial reporting to reflect the economic substance, not the form, of the transaction. FASB Statement Nos. 141, Business Combinations, and 142, Goodwill and Other Intangible Assets, which were issued in 2001, appear to be steps in the right direction. These standards will serve as a test of the level of specificity needed to strike a balance between rules and principles. Principle-based

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standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues.

A move to principle-based standards will require greater discipline by the corporate community, the accounting profession, private-sector standard-setting bodies, and the SEC staff. A move away from a check-the-box approach to financial reporting means that all constituencies must make concerted efforts to report transactions consistent with the objectives of the standards. While this may mean that not all transactions are recorded in exactly the same manner, it is my belief that similar transactions in this system of principle-based standards will not be reported in materially different ways, preserving comparability. Finally, a critical and important benefit of principles-based standards is that it would mitigate the opportunities to financially engineer around the rules. We have been working with the FASB to change its style to be more principle-based.

Herdman repeated these sentiments in an address to the Corporate & Securities Law Institute at Northwestern University, Chicago in April 2002⁷⁸ and the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services on 14 May 2002:⁷⁹

In his address of April 2002 he added an international perspective to his comments which seemed to imply that the undesirable rules-based approach of the US is also a fault in the UK. He equated a principles-based approach with greater speed in standard-setting.

The IASB has determined that it will take a principles-based approach to its standards. This was not a surprise, because I knew from many of my former non-US associates that they would loathe accepting the style of Anglo-American standards. But the leaders of that Board also have pointed out that that approach

should allow it to move with greater speed, an idea we obviously like very much, and an imperative for IASB standards to be ready for the European Union's dictate that IAS be used by all listed companies starting, for the most part, in 2005.

3.1.4 European Commission

The Commission's initial reaction to Enron is found in a 2002 report to the ECOFIN Council⁸⁰, (ECOFIN coordinates economic policy in the EU). The report asserts that the Commission has taken a principles-based approach to financial reporting.

US GAAP is largely a rules based approach to financial reporting. It comprises tens of thousand pages of accounting rules accumulated over decades (eg. 600 pages on derivatives, more than 800 pages on special purpose vehicles...). US GAAP contains numerous so-called "bright lines" – in effect they set out demarcation lines between the acceptable and the non-acceptable. In a dynamic business environment with management remuneration increasingly based on financial performance (share based payments) and innovative financial engineering (derivative financial instruments), creative accountants and lawyers have developed products and accounting methods that have little economic purpose other than to fall within the letter, if not the spirit, of these "bright lines". This has led some financial statements in the US not to reflect properly the true financial position. However, it would be wrong to criticise all aspects of US GAAP and to believe that accounting failures are impossible elsewhere, including in Europe.

The Commission has strongly promoted a strategy based on a principles-based approach to financial reporting, designed to reflect economic reality and so giving a true and fair view of

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the financial position and performance of a company. This protects the long term interests of investors and other stakeholders and requires company directors to make a careful judgement in selecting and applying the most appropriate accounting policies. At the heart of the Union's strategy is the application, from 2005, of International Accounting Standards (IAS) as the reporting framework for all listed EU companies. IAS are developed at the global level and concentrate on principles rather than on detailed rules. In IAS the rules which flow logically from the principles have far less complex exceptions and exemptions than US GAAP. Harmonised enforcement will ensure that under IAS the same situations will be accounted for in the same way. In many areas, they are already highly developed and the best available in the world. For instance, the off balance sheet treatment for Special Purpose Entities which are de-facto under the control of the reporting entity, would not be possible under IAS. The US have acknowledged that their standards dealing with off balance sheet financing require revision and the authorities are calling for new IASB-style, principle-based requirements.

What is interesting here is the comment that rules flow logically from the principles and have less complex exceptions and exemptions. The subsequent debate within the Commission and elsewhere on IAS 39 perhaps dilutes this initial enthusiasm for rules that flow from the principles. The final sentence of the quote is probably not a strong representation of what the SEC was calling for in its 2002 Study.

The report to ECOFIN makes policy recommendations in relation to financial reporting, statutory audit, corporate governance, the financial system, financial analysts and credit rating agencies. By 2003 the policy recommendations were beginning to appear in more detail. In relation to auditing the Commission reported:⁸¹

The collapse of Enron and subsequent financial reporting scandals have prompted calls in the European Union for further examination of financial reporting, statutory audit, corporate governance and securities markets. In the last 12 months investors' confidence in capital markets worldwide has eroded and public credibility of the audit profession has been impaired. The aftermath of Enron and the US response to restore investors' confidence, the Sarbanes-Oxley Act (SOA), and recent EU financial reporting problems require reconsidering EU priorities on statutory audit, as a part of the Commission's initiatives on the enhancement of corporate governance. The Commission will issue in parallel to this Communication on audit priorities its Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union".

The Commission proposed a principles-based approach to regulation of statutory audit within the EU:

The Commission therefore proposes a modernisation of the 8th Directive to provide a comprehensive legal basis for all statutory audits conducted within the EU. To the extent appropriate, these principles should be applicable to non-EU audit firms performing audit work in relation to companies listed on the EU capital markets. The 8th Directive which was adopted in 1984, and never amended since, deals mainly with the approval of (natural and legal) persons that are allowed to perform statutory audits. It also contains numerous provisions on transposition that all have become outdated since the beginning of the 90's. The present 8th Directive lacks a comprehensive set of elements for ensuring an appropriate audit infrastructure (for example public oversight, disciplinary systems and systems of quality assurance) and it does not refer to the use of auditing standards,

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independence requirements and ethical codes. In the light of recent developments the time has come to modernise the 8th Directive into a shorter, more comprehensive piece of European legislation with sufficiently clear principles that will underpin all statutory audits conducted within the EU.

3.1.5 FEE

Göran Tidström, President of Fédération des Experts Comptables Européens (FEE), advocated the principles-based approach in a speech in December 2002:⁸²

Europe should be proud, like IFAC, to have chosen for a conceptually principles-based approach that deals with all situations also those not yet recorded. This is a stronger system than merely checking compliance with rules. The now installed system of quality assurance will monitor and control the proper application of these principles. A global capital market requires global solutions, therefore also the SEC should base their independence rules on global standards.

Europe has to work with global standards and Europe's system needs to fit within the global system. Europe should continue to promote strongly the principles-based or framework approach, in accounting, auditing and ethical issues and demonstrates to the US that principles work!

3.1.6 UK

In responding to Enron in the UK, the Department of Trade and Industry appointed a co-ordinating group to review the UK's arrangements for audit and accountancy regulation.⁸³ The Group reported in January 2003 and said, in relation to the development of accounting standards:

We endorse the need for accounting standards to be based on conceptually-sound principles rather than set out prescriptive, detailed rules. This is a particular strength of the UK and international approaches to standard-setting and we look forward with interest to the results of the US work in this area. However, we note, and agree with, Sir David Tweedie's warning that adopting a principles-based approach requires companies and their auditors to apply those principles responsibly and with integrity, and not in a way that skews the economic reality. (para. 4.8)

In an address to IOSCO⁸⁴ the President of the Institute of Chartered Accountants in England and Wales (ICAEW), Michael Groom, supported the principles-based approach taken in the development of IASs and ISAs, citing UK experience with off-balance sheet financing and the development of the corporate governance code.

Paterson,⁸⁵ an independent consultant on financial reporting, compared UK and US accounting systems and considered the assertion that US standards are more rules based:

Ever since the Enron debacle first hit the news, smug UK accountants have found a new excuse for feeling superior to their transatlantic cousins. The US Financial Accounting Standards Board's massive oeuvre has been scoffed at as being merely a whole bunch of rules that don't hang together. Both British and International standards, by way of contrast, are asserted to be based on principles. This essential difference, it is argued, helps to explain why the US profession has got itself into such deep trouble.

He asked how it could be that the UK ASB and IASB appeared to have found reliable principles on which to base their own standards, while those same principles had eluded FASB. Pointing out that the UK ASB and the IASB both adopted conceptual frameworks that were largely

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copies of FASB's version, he concluded that the only difference was that UK standards were not really more principled than the American ones, they were simply less detailed.

3.1.7 Australia

In a joint press statement on 27 June 2002, the Treasurer and the Parliamentary Secretary to the Treasurer announced a process for achieving further improvement in audit regulation and the wider corporate disclosure framework as the next phase in the Government's Corporate Law Economic Reform Program (CLERP).⁸⁶ The Introduction also confirmed the belief that Australia already operated a principles-based approach.

This is not to say that Australia should match the United States point for point. The recent US legislative response tends to be prescriptive and rules-based. In addressing corporate governance issues, Australia has traditionally relied on a principles-based approach, employing a mix of regulation, co-regulation and encouragement of industry best practice. This approach has worked well in Australia and the Government supports its continuation.

However, in an editorial in *Abacus*,⁸⁷ Graham Dean and Frank Clarke noted that in the December 2003 version of the CLERP 9 Bill, those new paragraphs in the previous drafts which would have reinforced the primacy of 'true and fair' were dropped. They expressed surprise that there was no mention in the Federal Treasurer's Second Reading speech as to why those paragraphs were dropped. They found it particularly surprising because a JCPAA⁸⁸ inquiry had unanimously endorsed those changes and several submissions to the October 2003 version of the CLERP 9 Bill had viewed the changes favourably. In the editors' view the deletion of those paragraphs in

the December 2003 version of the Bill represented an opportunity lost.

The Treasurer introduced the CLERP 9 Bill into Parliament on 4 December 2003.⁸⁹ Submissions on the Bill from interested parties were heard by the Parliamentary Joint Committee on Corporations and Financial Services in March and May of 2004. The Bill was debated in Parliament in June 2004, passed on 25 June 2004 and proclaimed on 30 June 2004. The CLERP 9 Act came into effect on 1 July 2004, with amendments relating to reporting applied to financial years commencing on or after that date.

3.1.8 IASB

In February 2002 Sir David Tweedie, Chairman of the IASB, appeared before the Committee on Banking, Housing and Urban Affairs of the United States Senate.⁹⁰ He presented his analysis of how IFRS differed from US standards, focusing on the demand placed on FASB to provide detailed rules:

Many International Financial Reporting Standards (IFRS) are similar to US GAAP. IASB standards and US GAAP both strive to be principles-based, in that they both look to a body of accounting concepts. US GAAP tends, on the whole, to be more specific in its requirements and includes much more detailed implementation guidance. In my view, the US approach is a product of the environment in which US standards are set. Simply put, US accounting standards are detailed and specific because the FASB's constituents have asked for detailed and specific standards. Companies want detailed guidance because those details eliminate uncertainties about how transactions should be structured. Auditors want specificity because those specific requirements limit the number of difficult disputes with clients and may provide a defence in litigation. Securities

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regulators want detailed guidance because those details are thought to be easier to enforce. 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.

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. This is not a soft option. Our approach requires both companies and their auditors to exercise professional judgement in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. It will not work without those commitments. There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules.

He made similar observations to the Treasury Committee of the UK Parliament.⁹¹

3.1.9 International Federation of Accountants (IFAC)

Peter Wong⁹² was asked by the International Federation of Accountants (IFAC) to carry out consultations on challenges and successes

in achieving convergence to IFRSs and ISAs. He reported that participants in discussion groups emphasised the importance of applying a principles-based approach in international standard setting. It was felt that rules-based standards were too long and complex. Additionally, rules-based standards were difficult to implement and were likely to result in a ‘compliance and avoidance’ mentality.

3.2 Circumscribing judgement: A degree of caution

3.2.1 The SEC’s preference for objectives

The Executive Summary of the SEC’s Study (2002) moves the debate from ‘principles-based’ to ‘objectives-based’ standards in one phrase. In that phrase, italicised in the following extract, the Study underlines ‘principles-based’ and then adds ‘or objectives-oriented’ with the implication that they are equivalent. The underlining is contained in the Study’s text:

As directed by the Act, we have conducted a study of the approach to standard setting and found that imperfections exist when standards are established on either a rules-based or a principles-only basis. Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgement by preparers and auditors. Rules-based standards often provide a vehicle for circumventing the intention of the standard. As a result of our study, the staff recommends that those involved in the standard-setting process more consistently develop standards on a principles-based or objectives-oriented basis. Such standards should have the following characteristics:

- *Be based on an improved and consistently applied conceptual framework;*

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- *Clearly state the accounting objective of the standard;*
- *Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;*
- *Minimize exceptions from the standard;*
- *Avoid use of percentage tests (“bright-lines”) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.*

The wording of this introduction could be regarded as quite manipulative because the SEC was not directed to evaluate the extremes of ‘either a rules-based or a principles-only basis’. Sarbanes-Oxley asks for a ‘principles-based’ system, not a ‘principles-only’ system. Having established the enforcement fears inherent in a principles-only system, the SEC then underlines ‘principles-based’ to give the impression of equating it with the previously underlined ‘principles-only’ and then moves the debate into an objectives-oriented agenda that comes more readily within the SEC’s control.

The SEC’s Study began by criticising the inadequate definition of ‘rules’ and ‘principles’ as categories, moving on to offer its own definition of the optimal type of principles-based accounting standard as one that included an accounting objective, accompanied by an appropriate amount of implementation guidance. Again the underlining in the text is that of the Study:

While it has become fashionable recently to refer to principles-based and rules-based standards, these categories are not well defined and, therefore, are subject to a wide variety of interpretations. To conduct a study of the adoption of principles-based standard setting in the US, we first had to provide a clear definition of the optimal type of principles-based accounting standards and to distinguish it from other approaches.

We chose to base the study on what we considered to be the optimal type of principles-based accounting standards because we believe that Congress’ intent was to have the staff consider whether a different standard-setting paradigm from the one that exists today would be beneficial to US investors. We believe that neither US GAAP nor international accounting standards, as currently comprised, are representative of the optimum type of principles-based standards. Defining what we believe to be the optimal paradigm provides a necessary framework for this study.

In our minds, an optimal standard involves a concise statement of substantive accounting principle where the accounting objective has been included at an appropriate level of specificity as an integral part of the standard and where few, if any, exceptions or conceptual inconsistencies are included in the standard. Further, such a standard should provide an appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.

How will an objectives-based approach to standards be implemented? The Study offers a blueprint:

Operationalizing an objectives-oriented approach to standard setting in the US requires the standard setters to undertake the following key steps, which are explored in more detail in this report:

- *Ensure that newly-developed standards articulate the accounting objectives and are devoid of scope exceptions, bright-lines and excessive detail;*
- *When developing new standards, ensure that they are aligned with an improved conceptual framework;*

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- Address current standards that are more rules-based;
- Address deficiencies in the conceptual framework;
- Redefine the GAAP hierarchy; and
- Continue efforts on convergence.

The Study saw a continuing role for the Emerging Issues Task Force (EITF) in providing guidance on objectives but with less focus on defining rules or creating ‘bright line’ tests and a greater resistance to requests for ‘detailed guidance’.

Consistent with our previous discussion on a revised GAAP hierarchy, we believe that there will continue to be a need for a “body of experts” to address and resolve certain implementation questions. In the US, that body has, since 1984, been the EITF. We believe that such a body should continue to function to address certain implementation questions that arise. However, the manner in which it functions and the number of issues that it undertakes should be carefully examined.

The Conclusions of the Study set an action programme and time horizon for moving towards a more objectives-based approach to setting financial accounting standards.

Objectives were the focus of Chief Accountant Donald Nicolaisen in September 2004:⁹³

I would sum up my thoughts on this issue by saying that I believe that standards should be based on principles and objectives which are clearly described in the standard, that sufficient additional guidance should be available to promote consistent application of the standard, and that standards should be understandable to those who have to use them in financial reporting. This year we will release our report on off-balance sheet accounting. I hope that the observations we make in that report will

stimulate further improvements in accounting standards.

3.2.2 Risks of judgement leading to inappropriate choices

By September 2003, Commissioner Glassman had moved her focus from principles to objectives, while continuing the criticism of rules-based standards:⁹⁴

Another problem is that standards that incorporate too many detailed rules and requirements can be too complex, and also can fail to capture a transaction’s economics. The pace of business innovation has outstripped innovation in accounting standards. In too many instances, detailed accounting rules have been misused as a roadmap to structure transactions to reduce transparency. In a rules-based world, the standards will almost always be one step behind, which is one of the reasons the Commission’s staff recently suggested that it is time to evaluate whether a more objectives-oriented system would better achieve our goals.

Commissioner Glassman sounded a note of caution about the use of judgement:⁹⁵

Although we have been trying to limit the counter-incentives inherent in the process, there is no way to eliminate judgement and subjectivity from the reporting process. Any reporting framework - whether based on rules, principles or objectives - will therefore present the potential for bad choices.

What is a ‘bad choice’? The Commissioner noted that it could arise from an intention to deceive but she added that even choices that were technically permissible under GAAP could be misleading to investors.

Bad choices are possible, in part, because accounting standards sometimes make compliance with a preferable standard optional,

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and rely on the company to choose the better path.

3.2.3 FASB

The FASB, in its Proposal of 2002, pointed out the risks of allowing more judgement, indicating that there could be bad judgements as well as good judgements:

Further, the approach discussed in this proposal also could lead to abuse, whereby the principles in accounting standards are not applied in good faith consistent with the intent and spirit of the standards. Those and other similar types of situations could make it difficult for the SEC and other participants in the US financial accounting and reporting process to adjust to a principles-based approach.⁹⁶

One interesting feature of the various speeches from the SEC chairmen, chief accountants and commissioners is the growing thesaurus of negative words and phrases to cast doubt on the exercise of judgement. Examples are ‘unfettered discretion’, ‘aggressive interpretation’ ‘subjectivity’ and ‘bad choice’.

3.3 Reluctance to relinquish rules

3.3.1 SEC Commissioner Glassman

By 2003 a note of caution was appearing in the SEC’s enthusiasm for principles-based standards. In April 2003 Commissioner Glassman was advocating a hybrid system:⁹⁷

Personally, I do not think either strictly principles-based or strictly rules-based accounting is feasible. Ultimately, we should have a hybrid of rules and principles. Such a system would provide overriding principles that incorporate specific guidelines as examples to give the system more context and more teeth. For now, we still have to work with GAAP.

3.3.2 SEC Chairman Donaldson

The speeches of Chairman William Donaldson do not add to the ‘principles or rules’ debate in accounting but they do indicate a return by the SEC to reliance on rules, trusting others to look for the principles ‘beyond the rules’:⁹⁸

The second half of my mission is external. As Chairman, I hope to challenge corporate America to look beyond rules, regulations and laws and look to the principles upon which sound business is based. In order to restore their trust, American investors must see businesses shift from constantly searching for loopholes and skating up to the line of legally acceptable behavior. They must see a new respect for honesty, integrity, transparency, accountability, and for the good of shareholders, not only an obsession with the bottom line at any cost.

For Chairman Donaldson, an attitude of ‘doing the right thing’ means that concerns about compliance with rules will disappear:⁹⁹

Successful corporate leaders must therefore strive to do the right thing, in disclosure, in governance and otherwise in their businesses. And they must instill in their corporations this attitude of doing the right thing. Simply complying with the rules is not enough. They should, as I have said before, make this approach part of their companies’ DNA. For companies that take this approach, most of the major concerns about compliance disappear. Moreover, if companies view the new laws as opportunities - opportunities to improve internal controls, improve the performance of the board, and improve their public reporting - they will ultimately be better run, more transparent, and therefore more attractive to investors.

Donaldson says that those regulated by the SEC must look to the spirit of the rules:¹⁰⁰

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Indeed, it is a major, long-term undertaking, and our leadership throughout the world depends on this recovery. There has been progress, symbolized by the passage of Sarbanes-Oxley and its implementation. But there have also been more recent setbacks, including unfortunate governance failures at the New York Stock Exchange, and the abusive trading of mutual fund shares. In the end, public confidence will only be restored when companies in the United States and abroad are willing to move beyond basic compliance and into the setting of new standards of integrity. Investors, whether in the United States or abroad, must be able to see for themselves that business has moved beyond simple compliance with the new laws, and is living up to the spirit underpinning all of our securities laws.

He indicates that what matters is establishing the right rules:¹⁰¹

The fundamental issue for everyone involved in financial markets today, regardless of company or country, must be to maintain high standards that breed trust and confidence. This becomes increasingly important at a time when investors can - and do - move capital around the globe with a few keystrokes on a computer. Recent history has taught us that capital will flee environments that are unstable or unpredictable - whether that's a function of lax corporate governance, ineffective accounting standards, or a lack of transparency. Investors must be able to see for themselves that companies are living up to their obligations and embracing the spirit of all securities and governance requirements. This is a critical element for investor confidence not just in the United States, but also for countries as diverse as Chile and China, or Spain and South Africa.

The investment of time and effort to establish the right rules, and to build support for complying with them, is not without costs. But it will pay long-term dividends, as it

will enhance integrity within companies, and inspire confidence among customers and investors around the globe.

Then the rules have to be implemented in the right way:¹⁰²

It is entirely consistent with the principles underpinning Sarbanes-Oxley reforms to also evaluate whether the rules and regulations we write to implement these principles are effective and appropriate. Have rules been implemented the right way? What are the relative costs and benefits? Are there certain situations in which rules should not apply? Or where old rules have been outmoded or are in need of revision? For instance, we have recently proposed reforms to the rules governing the "quiet period" in the weeks preceding initial public offerings, reflecting the advances made in modern communications methods, such as the Internet. There are many other areas where we have acknowledged the need for updating and modifying rules, and there are also examples related to non-US issuers.

3.3.3 SEC Commissioner

Commissioner Glassman, while criticising rules-based approaches in one context, could be equally supportive in another context, when the rules were those of the SEC:¹⁰³

Sarbanes-Oxley gave the Commission 90 days to implement some rules and 180 days to implement several more key rulemakings and conduct several studies, and there is more to come. You may not realize it, but 180 days did not give the Commission very much time to propose new rules in a number of different areas, analyze all the comments we received, modify rule proposals where necessary, adopt final rules and conduct several special studies. But we did it!

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By the end of the 90-day deadline, we adopted rules accelerating the filing of quarterly and annual reports for certain issuers, requiring CEOs to certify quarterly and annual reports, and speeding up the disclosure of personal securities trading by corporate insiders. During January, we adopted nine new rules required by Sarbanes-Oxley and two additional rules affecting mutual funds and investment advisers. In the process of implementing Sarbanes-Oxley and other recent rules, the Commission received over 9,000 comment letters, each of which was read, carefully considered, and included in a comment summary that you can find on the Commission's website.

The following statistics are unofficial, but I'm told our adopting releases for the 11 rules totaled over 1,000 pages (double-spaced, 10-point font) (only lawyers could take over 1,000 pages to write 11 releases), and they contained over a quarter-million words. I'm also told - off the record -- that we reviewed over 113 different drafts, held over 2,700 man-hours worth of meetings, ate over 1,100 meals at our desks, and drank more than 4,800 cups of coffee! All kidding aside, though, the Commission's staff worked incredibly hard, and showed why you will not find a better, more dedicated group of public servants. Thanks to their hard work, we were able to adopt rules requiring heightened standards of auditor independence, the disclosure of off-balance sheet arrangements, and the inclusion of a reconciliation to generally accepted accounting principles -- for earnings releases and other financial information prepared on a pro forma basis. We also adopted rules requiring companies to disclose whether they have codes of ethics for executive officers, and whether they have designated an "audit committee financial expert" on their audit committees. We published for comment a rule directing the exchanges and

Nasdaq to prohibit the listing of the securities of any issuer that does not comply with the audit committee requirements of Sarbanes-Oxley, and we approved rule changes by the New York Stock Exchange and the NASD dealing with analyst conflicts. Finally, we adopted rules requiring securities lawyers to report evidence of fraudulent corporate conduct "up the ladder" to the chief legal or chief executive officer of the corporation or, if necessary, the board of directors.

3.3.4 FEE

The following extract gives FEE's view on enforcing auditor independence across Europe:¹⁰⁴

FEE led the debate on auditor independence by publishing, in July 1998, a paper on "Statutory Audit -Independence and Objectivity". The paper adopted a principles based 'threats and safeguards' approach. This conceptual approach idea was further explained in a FEE paper of 2001. The European Commission's Recommendation on Statutory Auditors' Independence was issued in May 2002. It also uses the principles based 'threats and safeguards' approach to independence. The principles based approach, as reflected in the Recommendation, includes guidance, restrictions and prohibitions. Such detailed guidance when fully implemented in national regulations and codes, is a major step forward in providing strong enforceable arrangements for auditor independence. FEE supports the Recommendation and believes that it is a major step forward as it prohibits auditors from providing services that compromise their independence.

In addition the Recommendation included some further requirements:

- *Full disclosure of audit and non-audit fees*

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- *Documentation for each audit client to show how circumstances that might have threatened the auditor's objectivity have been eliminated or reduced to an acceptable level of clear insignificance.*
- *Introduction of internal rotation of key audit partners within firms in public interest entities.*

The Recommendation was launched a year ago and is being implemented. FEE supports the European Commission proposal, in the Communication of 21 May 2003, to incorporate some key elements of the Recommendation into European legislation on the grounds that this will clearly demonstrate the protection of the public interest. In order to address any remaining concern, FEE believes that it is possible to make the implementation of the Recommendation more transparent by explaining more clearly the activities that it prohibits and restricts.

The language of FEE is interesting in its response to the principles-based approach. It may be seen that the words 'guidance', 'restrictions', 'prohibitions', 'requirements', 'prohibits', 'restricts', 'enforceable arrangements' all appear in the discussion. It is difficult to know how these differ from 'rules' particularly in a context of enforcement and possible legislation.

3.4 Principles-oriented developments by FASB

3.4.1 Confirmation of asset-liability view

The FASB confirmed its continuing focus on the asset-liability view as the basis for standard setting¹⁰⁵ and explained its plans for improving the Conceptual Framework.¹⁰⁶ It noted that in January 2003 the FASB had become the only designated standard setter in the US. All future EITF consensus decisions would be ratified by FASB before becoming effective.

3.4.2 Incremental approach

The SEC Study of 2003 recommended a comprehensive review of current standards to identify all those that were rules-based. However the FASB's response was that it did not want to go so far, although it did agree to consider whether existing literature was rules-based in making future agenda decisions. FASB felt it was more important to give attention to areas that had no guidance, or guidance that was not functional, rather than the areas where existing rules-based standards were functional.¹⁰⁷

3.4.3 Recasting standards in principles-based form

The Financial Accounting Standards Committee of the American Accounting Association (AAA) was asked by the FASB to provide comments on concepts-based standards and to recast two standards as concepts based.¹⁰⁸ The Committee recast two standards: SFAS No. 87 and SFAS No. 133. The recasting of SFAS No. 87 is appended to the research paper; the recasting of SFAS No. 133 is available on the AAA website.¹⁰⁹

The Committee reported the issues that arose during the process of revising the standards:

- There was a continuum from principles-only to rules-only. The Committee had to decide where to place the revised standards on that continuum. The preference was to reflect the economics as purely as possible.
- Reporting one transaction depended on how other transactions were reported. Not all of a firm's economic assets and liabilities are recorded. Of those that are recorded, not all are measured at fair value. It would be easier to write a standard if all assets and liabilities were recorded at fair value. Drafting becomes more difficult when distinguishing derivatives used in hedging and when distinguishing types of hedge.

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- Many existing rules appeared to arise from practicalities of dealing with specific concerns, rather than from the underlying economics of the transaction. Examples were the transition and corridor rules in SFAS No. 87. The Committee's approach was to reflect the economic nature of the transaction rather than the practical concerns of constituents but they had no answer to the question of how much the practicalities should be retained.
- The Committee asked itself whether it was necessary to have standards relating to specific transactions. They could see a case for combining SFAS No. 87 on pensions and SFAS No. 106 on other post-retirement benefits in one conceptual standard.
- The Committee considered the relative merits of gradual change to principles-based standards compared to a 'one-shot' comprehensive approach. In a gradual change the sequence would be important, to avoid constant change of standards already revised. It also seemed important to have a comprehensively revised Conceptual Framework before commencing principles-based revision of standards.

3.4.4 FASB projects

FASB has two web pages, one updating its principles project¹¹⁰ and the other updating its conceptual framework project.¹¹¹ The webpage for the principles project contains comment letters received on the 2002 consultation, materials from a roundtable meeting held in December 2002, minutes of the Board's subsequent discussions in March 2003, and a lead-in to the conceptual framework project, commenced jointly with IASB in 2004. There are also links to articles in *The FASB Report*.¹¹²

In May 2005 the FASB and IASB announced the details of their new conceptual framework

project.¹¹³ Under the heading 'Why we need a conceptual framework' the paper explains:

A common goal of the FASB, shared by their constituents, is for their standards to be 'principles-based'. To be principles-based, standards cannot be a collection of conventions but rather must be rooted in fundamental concepts. For standards in various issues to result in coherent financial accounting and reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent.

Principles are now being equated with concepts. The paper draws on a dictionary definition of 'concept' as 'a general notion or idea...of a class of objects'.

In addition to the joint conceptual framework project the Board has three projects on its agenda relating to developments of concepts: fair value measurements, financial instruments (liabilities and equity) and revenue recognition. An example of the FASB's focus on a principles-based approach is seen in the project on Revenue Recognition, under development in conjunction with IASB,¹¹⁴ where 'principles' appear to have become 'concepts':

The process of developing guidance at the concepts level and the standards level is iterative in that tentative conclusions about the conceptual guidance are tested by applying them to specific revenue recognition issues that have been identified, which sometimes indicates the need for further improvements in the concepts, and so on.

At May 2005 the Board had a plan for the various levels of guidance to be offered:

Level I. Revision and expansion of Concepts Statements 5 and 6

- *Concepts Statement 6 defines revenue in terms of assets and liabilities*

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- *Concepts Statement 5 describes recognition criteria unique to revenue*

Level II. A general standard on revenue recognition

- *Replace various literature such as APB Opinion No. 29, Accounting for Nonmonetary Transactions, FASB Statement No. 48, Revenue Recognition When Right of Return Exists, EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," and SEC Staff Accounting Bulletin No. 104, Revenue Recognition*
- *Provide high-level guidance derived from the revised Concepts Statements*

Level III. More specific application guidance

- *Provide guidance for three types of revenue-generating activities*
 - *Rights of Use*
 - *Services*
 - *Products*
- *Identify guidance to be superseded by the application guidance*

3.4.5 FASB hierarchy of GAAP

The SEC (2003) Study¹¹⁵ recommended that the FASB hierarchy of accounting principles should place the FASB conceptual framework document at the head of the list of 'authoritative literature', above FASB standards and equivalent documents.

As part of the initiatives taken in the light of the SEC (2003) Study, the FASB proposed, in 2005,¹¹⁶ a hierarchy of sources of accounting principles. This had hitherto been presented in an auditing standard, SAS 69. The hierarchy in that form had been criticised as being directed at the auditor rather than at the enterprise and had also

been criticised because it placed the FASB concepts statements below industry practices. The revised hierarchy is given the status of a FASB standard. The location of the FASB Concepts statements still look rather strange because they are set in a parallel streams. A sequence of descending authority is specified under headings (a) to (d). If none of these provides the answer then an enterprise shall consider 'accounting principles for similar transactions or other events and other accounting literature'. Other accounting literature includes the FASB concepts statements.

3.5 Overview and comment

Zeff (2005a, 2005b) has analysed the evolution of US GAAP in terms of the political forces behind professional standards from 1930 to the present day. His comment on the SEC and FASB initiatives is:

FASB is likely to emphasize principles and objectives in its forthcoming standards, but it remains to be seen whether its standards will become shorter and less detailed. There is no sign that the SEC accounting staff is becoming less insistent on company compliance with detailed norms. The accounting culture of the United States is one of highly specific and prescriptive standards, and a change in culture is not simple to achieve.

Zeff concludes that in circumstances where a highly prescriptive standards setter is coupled with a rigorous enforcement process (used by a government regulator to secure compliance with accounting standards), then companies, and even branches of government, will lobby the standard setter not to approve standards that interfere with their business plans and strategies. He sees no sign of this trend diminishing in intensity or frequency where issues are sensitive or controversial.

This section has shown that there was initial enthusiasm in 2002, in many quarters, for a principles-based approach to accounting standards

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as a reaction to the perceived failings of rules-based standards evidenced in the Enron failure. Then the evidence of positioning for relative power began to appear. The SEC, in its 2003 Study, deflected attention from its own potential failings by criticising the FASB's standards as being rules-based, but also wrote the agenda for controlling change by redefining principles-based standards as objectives-based standards. The FASB responded in 2004 by agreeing that it could accommodate an objectives-based approach as effectively representing the principles-based approach it had already proposed in 2002. The speeches from key players in the SEC showed progressively more concern to circumscribe the potential freedom of judgement that would be allowed under principles-based standards.

The mutation of language from 'principles' to 'objectives' moved a stage further in the FASB/IASB project to converge their conceptual frameworks. The language of the Sarbanes-Oxley revolution, based on 'principles' mutated again from 'objectives' to the more familiar 'concepts' already present in both conceptual frameworks.

One interesting question that arises from this review is the extent to which accounting standards are seen as a tool of the regulator in setting the baseline for acceptable practice rather than as a guide to setting high standards for the preparation of financial statements. The concerns for circumscribing judgement appear to be driven by regulatory concerns.

There is also an interesting political aspect in the positioning of the SEC and FASB as the guardians of the integrity of the system of accounting standards. This is a particular feature of the US system where the FASB, as an independent standard-setter, must have regard to the views of the SEC because the SEC has the statutory authority to decide whether financial statements prepared under the FASB's standards are adequate for the purposes of the capital market.

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Carlino, editor-in-chief of *Accounting Today*,¹¹⁷ reflected in 2004 on his participation in a round-table discussion of the relative merits of rules and principles. His closing remarks in his editorial were:

My point is that, for all the merits of each, the rules vs. principles debate is rendered moot if management and auditors aren't principled about rules or ruled by principles.

This section reflects on how changes in the accounting profession have reflected the increased emphasis on rules and looks to ideas for directing the profession towards principles-based standards.

4.1 View from the SEC

In the SEC (2003) Study there is a discussion of the behavioural changes that would be required in an objectives-oriented regime.¹¹⁸ Preparers and auditors would have to exercise judgement in a different way. In the short run preparers would have to resist the temptation to challenge auditors by demanding written guidance in order to accept an auditor's judgement. Furthermore preparers could not rely on financial engineering to achieve an accounting result. Auditors would need to move away from the checklist mentality. A security blanket of rules would be removed. In the long run there would need to be training of preparers and auditors in understanding the substance of a class of transactions. It would also be imperative that accounting professionals be trained in valuation theory and techniques, in order to be able to deal with standards relying on fair value as the measurement attribute.

The reader of the SEC Study might be surprised to find that preparers and auditors are not already trained in understanding the substance of a transaction and in the knowledge and application of valuation theory.

4.2 View from FASB

The FASB (2004a) was more doubtful about the realism of changing attitudes in the short term. It said:¹¹⁹

The Study also states, however, that a move toward more objectives-oriented standards will require shifts in attitude, behavior, and expertise of preparers and auditors. The Board believes that it may take several years or more for such attitudes and behavioral changes to take root. One reason for that belief is that preparers continue to request scope exceptions, scope exemptions, and treatment alternatives and to oppose changes that would eliminate existing scope exceptions and treatment alternatives. In addition, the Board's recent experience suggests that many preparers and auditors have become less willing to exercise professional judgement in areas involving accounting estimates, uncertainties, and inherent subjectivity. Instead, they have been requesting detailed rules and bright lines in an apparent effort to reduce the need for the exercise of judgement in inherently subjective areas. Increased accountability for the accuracy of financial information under the new requirements related to the Sarbanes-Oxley Act coupled with a fear of "second guessing" by enforcement agencies and the trial bar are frequently cited as reasons for this behavior.

4.3 View of a former regulator

Dennis Beresford was chairman of FASB from 1987 to 1997. In 2004 he asked 'can we go back to the good old days?'¹²⁰ He referred to the early 1960s when accounting seemed more like a true profession, with good judgement and experience as the key requirements for success. He admitted having led the development of many standards during his time at the FASB but felt that more recently standards had become increasingly complicated and harder to apply. He said:

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I've heard FASB board members say that FASB Interpretation (FIN) 46, on variable-interest entities (VIE), is an example of a principles-based standard. I assume they say this because FIN 46 states an objective of requiring consolidation when control over a VIE exists. But the definition of a VIE and the rules for determining when control exists are extremely difficult to understand.

He also noted concerns emerging from a report by the Public Company Accounting Oversight Board (PCAOB) in August 2004 that criticised the big four firms. He referred to the response to the criticism which noted that the PCAOB, the SEC and the firms were arriving at different conclusions on the same issues.

4.4 A changing accounting profession

Zeff (2003a and b) has reviewed, examined and interpreted the events and developments in the evolution of the US accounting profession during the twentieth century.¹²¹ He focuses on the challenges and crises that faced the accounting profession and the big accounting firms, especially from the mid-1960s, and on how value shifts inside the big firms combined with changes in the earnings pressures on their corporate clients to create a climate in which serious confrontations between auditors and clients were destined to occur. Zeff identifies the deterioration of professional values as beginning in the 1980s.

In his conclusions Zeff pointed out that the big firms gradually withdrew from active participation in the debate over accounting principles, partly because of their exclusion from the standard-setting process when the FASB replaced the APB in 1973. There was a transformation of professional firms into businesses that rendered professional services. The audit mentality of the top management of these firms was replaced by a consulting mentality and business values replaced professional values. Audit partners became weaker

in standing up to pressure from clients. Managers of client companies were taking advantage of subjective judgements implied in accounting choices in order to maximise their compensation bonuses based on earnings and options based on the price of the company's stock.

4.5 A rules-based standard causes more aggressive judgement

Psaros and Trotman (2004)¹²² used a case study experiment to examine the judgements of experienced accountants in Australia. They asked two groups of accountants to make consolidation judgements on two situations, one involving a loss-making investee and the other a profit-making investee. In Experiment 1 the researchers found that when subjects used a substance-over-form accounting standard they justified their consolidation judgements on case-specific information rather than on different interpretations of the phrase 'capacity to control'. In Experiment 2 the researchers found that when subjects used a rules-based standard, a significantly greater proportion of accountants recommended consolidation of the profitable investee than of the loss-making investee. They appeared to interpret the rules to match their view of the situation. The researchers concluded that increasing the stringency of the standard in their study did not affect consolidation judgements. Providing more stringent standards may simply encourage innovations that are designed to achieve the same outcomes that are consistent with the accountants' incentives but through different means such as their interpretation of case-specific information.

4.6 Personality

This section explains a framework for considering the personality of accountants operating under the chosen financial reporting model, and the culture of the society in which the framework will operate. It discusses research conducted into the areas of personality and culture,

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presents the results of such research, and identifies potential implications of such findings.

First some terminology is needed to describe the mental processes in personality and their application. Then the practical measurement of personality is described.

4.6.1 Theory

The theory of personality type rather than trait was introduced by Jung (1923),¹²³ when he examined the conscious aspects of personality, decision making and the effect of personality on the understanding of an individual. Jungian personality theory asserts that human behaviour

can be attributed to differences in personality types (Wheeler, 2001).

Jung proposed that individuals' main perceptions of the environment were either sensing (S) or intuition (N) and their two means of decision making were thinking (T) or feeling (F). Attitudes towards the world were either an introverted (I) or extroverted (E) outlook. Briggs-Myers (1980) elaborated on this when a fourth area, inherent in Jung's theory, was added, in the form of a preference of dealing with the world, using either a judgement (J) or perception (P) approach.¹²⁴ The implications of each of the stated processes are detailed in Table 1.

Table 1

Descriptions of Jung's mental processes in Personality Theory and their implications

Mental Process	Implication
Sensing (S)	What it is: recognition. Taking in information sequentially, performing step-by-step analysis, seeking the fullest experience of what is immediate and real, liking detail-orientated tasks and working with established facts.
Intuition (N)	Why it is: theory. Has insight beyond the 5 senses, likes abstract concepts, organises information in a broad framework, enjoys looking for possibilities and relationships.
Thinking (T)	What it means: understanding. Seeks rational order through impersonal/objective, logical process, unlikely to base judgement on personal values.
Feeling (F)	What it is worth: values. Uses a subjective and value-based approach, weighing up personal and group values.
Introverted (I)	Has preference for the inner world of ideas and concepts, prefers communication in writing and uses reflection as a learning process.
Extroverted (E)	Feed off the external world of people and things within which they exist.
Judgement (J)	Their observable behaviour reflects a judging process (T of F), like an orderly and planned lifestyle. These are purposeful, methodological, organised and decisive people.
Perception (P)	Their observable behaviour represents more of a perception process (either S or N), they like a flexible and spontaneous lifestyle.

Source: This table is composed from a collation of definitions for each mental process in Jung's theory.^{125, 126 and 127}

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The personality of an individual defines their identity and purpose in life; how they act and who they are. Guilford (1959, cited in Hofstede, 2001) defines personality as *'the interactive aggregate of personal characteristics that influence an individual's response to the environment'*. Kreiser et al. (1990) identify the potential advantage for accounting firms to develop knowledge of personality type for recruitment and promotion practices within the profession, effective management of client relations and the effective marketing of professional services. Schloemer and Schloemer (1997) further postulate that personality influences how an individual approaches their job, and consequently interacts with colleagues. Therefore, knowledge and understanding of personality types can be highly beneficial within the workplace.

of the described personality traits. The MBTI identifies these preferences, which collectively viewed amount to one of 16 personality types as detailed in Table 2.

4.6.2 Practical investigation

Studies on the topic of personality in the discipline of accounting have mainly been conducted using the established psychometric research instrument called the Myers-Briggs Type Indicator (MBTI), which has been extensively tested for reliability and validity (Wheeler, 2001, p.125). The MBTI is used to apply Jungian personality theory. It categorises participants into subsets incorporating four of eight personality traits.

The MBTI was originally created in 1962 by Isabel Briggs-Myers, but has since been periodically revised. The MBTI can be described as *'a questionnaire style instrument consisting of items arranged in a forced-choice format'*¹²⁸. A forced-choice format means the respondent is given closed-ended responses to choose from, rather than leaving a space for disclosure of their (qualitative) answer, which risks interpretive bias and error. At any one time an individual will show a preference for a combination of four

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Table 2

Description of Personality Types Identified by the MBTI, Including Occupational Predisposition

		Sensing (S)	
		Thinking (T)	Feeling (F)
Introversion (I)	Judging (J)	ISTJ Detached, Practical, Sensible, Decisive, Logical. <i>Management, Administration.</i>	ISFJ Practical, Co-operative, Sensitive. <i>Education, Healthcare, Religion.</i>
	Perceiving (P)	ISTP Logical Problem Solvers, Detached, Factual, Pragmatic. <i>Skilled Trades, Other Technical Fields.</i>	ISFP Trusting, Kind, Sensitive, Observant, Practical. <i>Healthcare and Business.</i>
Extroversion (E)	Judging (J)	ESTJ Logical, Decisive, Objectively Critical, Systematic, Practical. <i>Management and Administration</i>	ESFJ Factual, Co-operative, Practical, Decisive, Personable. <i>Education, Healthcare, Religion</i>
	Perceiving (P)	ESTP Observant, Active, Assertive, Rational Problem Solver. <i>Marketing, Business, Skilled Trades.</i>	ESFP Observant, Specific, Active, Sympathetic, Idealistic, Tender. <i>Healthcare and Teaching.</i>

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Table 2

Description of Personality Types Identified by the MBTI, Including Occupational Predisposition

		Sensing (S)	
		Thinking (T)	Feeling (F)
Introversion (I)	Judging (J)	INTJ Insightful, Clear, Rational, Detached. <i>Science, Computers, Other Technical Fields.</i>	INFJ Insightful, Idealistic, Committed, Compassionate. <i>Religion, Counselling, Teaching.</i>
	Perceiving (P)	INTP Logical, Curious, Detached, Insightful, Contemplative <i>Scientific and Technical Fields.</i>	INFP Sensitive, Caring, Idealistic, Creative, Visionary, Curious. <i>Counselling, Writing, Arts.</i>
Extroversion (E)	Judging (J)	ENTJ Analytical, Assertive, Conceptual Thinker, Innovative Planner. <i>Management and Leadership.</i>	ENFJ Compassionate, Loyal, Imaginative, Supportive, Keen on Variety. <i>Arts, Religion, and Teaching.</i>
	Perceiving (P)	ENTP Creative, Imaginative, Analytical, Rational, Inquisitive, Theoretical. <i>Science, Management, Technology.</i>	ENFP Curious, Creative, Energetic, Friendly, Co- operative, Warm. <i>Counselling, Religion and Teaching.</i>

Previous research has identified that practising accountants tend to fall into one of two personality types, that of mainly ISTJ, or secondly ESTJ. These can either be Introverted or Extroverted people, but they share the characteristics of Sensing (S), that is taking in information sequentially and performing step-by-step analysis; Thinking (T), whereby information is understood logically and through rational process; and Judgement (J), in that they are orderly, methodical and purposeful people. A summary of these findings is presented in Table 3.

STJ types prefer sequential information analysis rather than abstract concepts and ideas, prefer rational order and logical process to subjective and value-based judgements, and prefer a planned and organised lifestyle to a spontaneous and flexible one. This would suggest therefore that accountants would prefer a rules-based accounting framework.

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Table 3

Summary of Relevant Previous Research Indicating STJ Preferences¹

Reference	UK or US study	Sample Size	Findings	Conclusion Rules or Principles
Shackleton (1980) <i>Accountancy</i>	UK	91 Accountants and Financial Managers	Subjects primarily displayed STJ preferences; ISTJ constituted 25.3% and ESTJ 13.2%. Overall I preferences were 58% of sample.	STJ personality types prefer rational order, logical processes and a structured environment, thus Rules.
Jacoby (1981) <i>Research in Psychological Type</i>	US	333 Accountants in 3 Big 6 firms in Washington D.C. area	STJ preferences were dominant at 33.6%, with ISTJ at 19.8% and ESTJ at 13.8%.	As above – Rules.
Otte (1984), <i>The Michigan CPA</i>	US	494 CPAs in small firms in Michigan	Small firm CPAs show STJ preferences (45.9%), and ST preferences were stronger at local level than national level.	As above – Rules.
Descouzis (1989) <i>Journal of Psychological Type</i>	US	36 H&R Block Tax preparers (avg. 7 years experience)	All tax preparers showed S preferences; 58% showed I preferences, 81% showed J preferences and 44.4% displayed STJ preferences.	S – sequential, step-by-step approach; I – prefers inner world, written communication; J – methodical, organised decision-making process; STJ – as above, thus Rules.
Kreiser et al. (1990) <i>The Ohio CPA Journal</i>	US	387; 96 non-practicing CPAs, 86 practicing CPAs, 92 bank officers, 113 FEI members	CPAs in practice were perceived by all other respondents to have STJ preferences. While this was found to be true, the perceived preferences were double the actual preferences noted.	STJ – as above – Rules.
Satava (1996) <i>Journal of Psychological Type</i>	US	439 CPAs in local and national US firms	Predominance of STJ preference in both local and national firms. No significant difference in SN, TF or JP scales, but more E preferences in national firms and I in local scale firms.	STJ – As above - Rules
Schloemer and Schloemer (1997) <i>Accounting Horizons</i>	US	125 Accountants from both Big 6 and larger local firms	CPAs primarily displayed STJ preferences although an increase in E preference detected over the past decade.	As above – Rules.
Wolk and Nikolai (1997) <i>Journal of Accounting Education</i>	US	94 Accounting graduates between 1991-94, and 98 accounting faculty members in 1994	Significantly more Accountancy students showed extrovert preferences than faculty members. Undergraduates high ISTJ (40%) and ESTJ (44%), graduates and Faculty members highest ISTJ and ESTJ (35% and 49%) respectively.	E – extroverted; I – introverted; STJ – as above, thus Rules.

¹ The information regarding the studies and their findings, in columns titled Reference, Sample Size and Findings are adapted from Table 4, Panel A of Wheeler (2001), and studies used in this section not mentioned in Wheeler were added. Journal titles are identified in Italics.

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4.7 Ethical development in the accounting profession

The subject of ethics has been covered comprehensively by ICAS in the discussion document *Taking Ethics to Heart*.¹²⁹ That discussion document includes a range of detailed recommendations on education and training. This section explains how researchers have attempted to measure the level of ethical development in professionals.

4.7.1 Theory

The level of ethical development can be measured using a framework devised by Kohlberg (1976) whereby the individual has the potential to progress through six stages of moral development, each constituting different motivations for making decisions. Essentially, the lower the stage of moral development of an individual, the more likely they are to follow rules. If an individual is at a high stage of moral development then there is an increased chance that they will over-ride any rules in place in order to fulfil their internalised principles of the greater communal good. This is further explained at Table 4 below.

Table 4
Kohlberg's Six Stages of Moral Reasoning

Pre-Conventional Level: Focus on Self		
Stage 1:	Obedience	People avoid breaking rules for fear of punishment or harm to self if they do. There is respect for authoritative powers.
Stage 2:	Instrumental Egotism and Simple Exchange	People follow the rules if they deem such behaviour in their own interests. Deals are made in recognising that others have interests too.
Conventional Level: Focus on Relationships		
Stage 3:	Interpersonal Agreement	Subject realises benefits from being good to others and living up to expectations. There is a focus on cooperation with those sharing that environment.
Stage 4:	Social Order	Recognition of protection by and the need to keep society going by fulfilling duties and obligations determined by law and social principles. The focus is on cooperation with society as a whole.
Post-Conventional Level: Focus on Self-found Principles		
Stage 5:	Communal Consensus	Obligated by upholding arrangements agreed by due process procedures; law by social contracts. There is focus on the fairness of the law by equality in developing such rules.
Stage 6:	Non-Arbitrary Social Co-operation	Use of self-assured ethical principles and a belief in the ideal of rational persons defining law on general principles of fairness and morality. Sense of personal commitment to universal moral principles.

This table is taken from the Honours Dissertation of Melissa Spence. It is compiled primarily using descriptions given in Ponemon (1992) and Dunn *et al.* (1993).

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Kohlberg argues that individuals progress, at their own pace, through the above stages of moral development, and that individuals are in one stage of moral development at any given time and can only improve their moral reasoning ability; they cannot regress to a stage below one they have already reached. He argues that moral reasoning can be developed and learned.

In the first level of moral development, the subjects are primarily motivated by rewards they can bring themselves through their behaviour. Stage 1 behaviour emphasises the desire to benefit oneself directly, whereas stage 2 recognises that one may benefit indirectly by helping others achieving their goals, often by making deals (Dunn *et al.* 2003). Eynon *et al.* (1997) postulate that stages 1 and 2 of Kohlberg's moral reasoning framework can be illustrated through the typical behaviour of children.

In the second level of moral development according to Kohlberg's framework, the individual's focus is on relationships, those with people in their close proximity at stage 3, and with society as a whole in stage 4 (Ponemon 1992). Another motivating factor for behaviour at the conventional level is other people's perception of the individual's morality, as illustrated clearly by the example of teenagers reacting to peer pressure (Eynon *et al.* 1997).

The third, and final, 'post-conventional' level of Kohlberg's framework of moral development involves the individual following principles which they personally deem ethical. In stage 5, the individual feels that there are certain rights and values inherent in social attachments and contracts, and they uphold laws because they believe they are based on and support such values (Ponemon 1992). In stage 6, the individual may

choose to override the rules, because they feel they do not support their values and beliefs (Dunn *et al.* 2003). An individual whose moral reasoning has reached the post-conventional level would believe this behaviour was justified by the fact that they were acting on behalf of others and society (Eynon *et al.* 1997).

4.7.2 Measuring ethical capacity

The Defining Issues Test (DIT), developed by Rest (1986), is used to implement Kohlberg's theory. It has been used by Dunn *et al.* (2003) to measure moral attitudes. The DIT takes a questionnaire format using standard responses. It has an inbuilt validity measure; some questions are deliberately aimed at ensuring consistent responses to the questionnaire, and if responses are not consistent then this response will be discounted from subsequent analysis. The most significant measure in concluding a DIT test is the principled morality score, or 'P-score', which measures the level of decisions taken at the post-conventional level of Kohlberg's framework. This has a potential value between 0 and 95.

Dunn *et al.* (2003) point out that the research questions are designed to determine how respondents would resolve an ethical dilemma rather than whether they would react in a way that is morally 'correct'.

Table 5 contains a selection of average scores based on the work of Rest.

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Table 5
Average P Scores of Members of Society

Member of Society	Average P Score
Moral Philosophy and Political Science Doctorate Students	65.2
Advanced Law Students	52.2
Practising Medical Physicians	49.5
Practising Lawyers	47.3
Average College Students	42.3
Adults in General	40.0
Average Senior High School Student	31.8
Average Junior High Student	21.9
Institutionalised 16-year old Delinquent Boys	18.9

This table was drawn together from a selection of average P scores given in Lemon (1996), Eynon *et al.* (1997) and Dunn *et al.* (2003). All these authors drew the average P scores from Rest (1994).

Studies have shown that qualified accountants generally do not possess the same moral reasoning ability as other professionals; or even as adults in general (Rest 1994; Ponemon, 1992; Eynon *et al.* 1997; Dunn *et al.* 2003). Accountants are subject to many potential conflicts of interest through their work, and the work of accountants has infinitely far-reaching societal consequences. While Dunn *et al.* (2003) stipulate that the measure of ethical development simply denotes the propensity to follow rules, Thorne (2000) and Massey (2002) both conclude that there is a positive relationship between ethical development and auditors' formulation of ethical judgement.

In studies directed specifically at auditors in Canada, Ponemon and Gabhart (1993) found that the average P-score for Big 6 auditors is 40.0, similar to the result of 41.3 found by Shaub in the US (1994). In comparison for the UK, Dunn *et al.* (2003) found average scores of 35 for partners and 42 for non-partner employees working in accounting firms. The researchers interpret this result as indicating that the process

of partner selection tends to favour those who have similar values.

Davidson (1991) and Abdolmohammadi *et al.* (2003) maintain that the reason for the findings of low scores for moral reasoning in the accountancy profession is due to a 'selection-socialisation' or a weeding-out process carried out during the recruitment stages, which favours applicants who show the S (sensing) and T (thinking) preferences, and consequently display low scores in the test of moral reasoning. Ponemon (1992) further suggests one reason for the consistently low scores of moral reasoning in accountants is due to being socialised and selected (selection-socialisation) for promotion and retention within the firm according to personal characteristics and types being similar to those undertaking the promotion. Wheeler (2001) also suggests that such a filtering process takes place in the education of potential accountants.

Russell and Smith (2003) suggest that the accounting education programme is to blame for recent financial scandals such as Enron and WorldCom, stating that while teaching methods

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have evolved over the past few decades, the material taught has essentially remained the same, and focuses on passing professional exams rather than providing sound, comprehensive accounting education for students. Perhaps accounting education programmes should place more importance on the subject of ethics in the profession.

Mastracchio (2005) questions the effectiveness of ethics education in the curriculum of US accounting majors. He points out that many courses on ethics focus on teaching the rules. Ethics becomes a question of not violating the rules. His proposed solution is that state boards of accountancy should make ethics education a component of the 150-hour requirement. His prescription is three credit hours in ethical foundations, three credit hours in business ethics and three credit hours on ethical issues in accounting. It seems ironic that a commentator who recognises the weaknesses of a rules-based approach resorts to a rule-based system for a solution. It could be argued that the 150-hour rule is part of the problem rather than part of the solution.

4.8 Overview and comment

It appears from the literature that in the US the movement towards rules-based standards has developed to the point where accountants in practice are familiar with a rules-based approach and have little experience or recollection of the kinds of judgement needed for principles-based accounting. This development has occurred for a complex mix of reasons but particular aspects include the distancing of the professional firms from the standard-setting process and the increased threat of litigation.

Personality-type studies of individual practising accountants need careful reflection in forming conclusions. Most studies find that

those involved in accounting practice are more suited to a rules-based system but this could well be due to the focus of education, training and professional development programmes within a rules-based system that has been developed in response to external forces. It could be dangerous to extrapolate the findings to suggest that those involved in accounting can only cope with rules-based systems but the findings also point to the very significant effort that would be required to change from a rules-based to a principles-based orientation.

The ethics debate is a separate issue from the 'rules versus principles' debate but the two sets of issues are interwoven when questions are asked about the capacity of accountants to make ethically sound judgements based on principles and guidance rather than on prescriptive rules.

Most of the studies of personality and moral reasoning are based on US data and it is important not to extrapolate these findings to all countries and regimes. However the studies indicate that it is essential to understand the nature of the accounting profession in any country before making an assessment of the relative potential of rules-based or principles-based accounting systems.

SECTION FIVE - HISTORY OF THE PRINCIPLES DEBATE

The debate on accounting principles is not new. In the US in the 1950s and 1960s a great deal of effort went into searching for a set of postulates and principles that would define accounting. The effort was not a success. Postulates and principles were associated with the failure of the Accounting Principles Board (APB) although the root cause was more related to APB's lack of political power.

There was also a failure to realise how much opinion is involved in creating sets of principles. In a well-established text book, Wolk, Dodd and Tearney (2004, p.124) explain that the Special Committee on Research Program (1958, pp.62-63) advocated a deductive approach – articulate postulates and then derive principles logically from the postulates. A deductive approach is normative in nature (using phrases such as 'ought to do' ... 'should do'...). A normative approach depends strongly on the beliefs of those creating the principles as to what is 'right' or 'wrong'. It creates a subjective set of principles that can be challenged from an alternative perspective of what is 'right' or 'wrong'. Those who take the deductive approach may claim there is a scientific process of logic underlying the postulates and principles created but any evaluation of the system has to take account of the underlying beliefs.

In April 1971 the American Institute of Certified Public Accountants (AICPA) formed two special study groups. One group was chaired by Francis M Wheat¹³⁰ under the title 'The Study Group on Establishment of Accounting Principles' and the other was chaired by Robert M Trueblood¹³¹ under the title 'The Study Group on the Objectives of Financial Statements'. The Wheat Committee recommended a framework for setting accounting standards that was adopted in forming the FASB. The Trueblood Report formed

the basis of a conceptual framework having regards to the needs of investors and creditors.

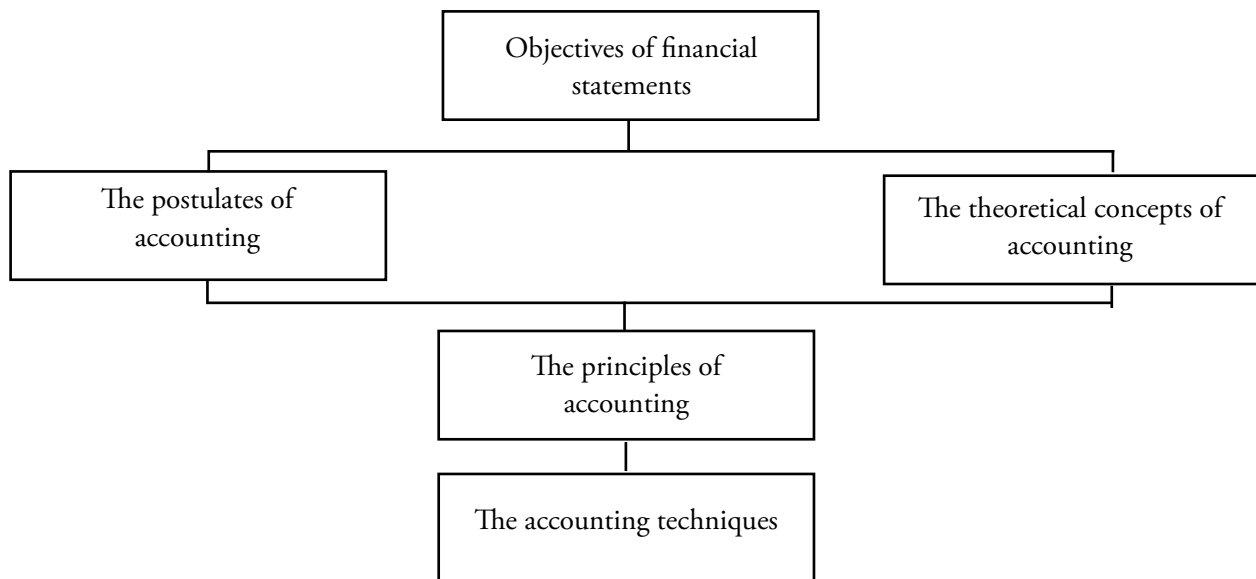
The Financial Accounting Standards Board (FASB) replaced the APB in 1973. The FASB took an approach based on user needs and the creation of a conceptual framework where objectives of financial statements took centre stage. The 'principles' of previous debates reappeared in the form of 'definitions' and 'qualitative characteristics'.

This section describes and illustrates the debates of the 1950s and 1960s to illustrate the conflicts and complexities of the debate and to show how the lack of conclusions led to an alternative form of conceptual framework based on objectives, definitions and qualitative characteristics.

5.1 Structure of an accounting theory

It might seem that the obvious starting point in searching for a definition of a principle is to open a reputable text book on accounting theory. The following description of the structure of an accounting theory is based on Riahi-Belkaoui (2004, Ch.7, p.210).

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Riahi-Belkaoui (2004 p.211) explains each term as follows:

The *accounting postulates* are self-evident statements or axioms, generally accepted by virtue of their conformity to the objectives of financial statements, that portray the economic, political, sociological and legal environments in which accounting must operate.

Riahi-Belkaoui's examples of postulates are: entity, going concern, unit-of-measurement, accounting period.

The *theoretical concepts* of accounting are self-evident statements or axioms, also generally accepted by virtue of their conformity to the objectives of financial statements, that portray the nature of accounting entities operating in a free economy characterised by private ownership of property.

Riahi-Belkaoui's examples of theoretical concepts are: proprietary theory, entity theory, fund theory.

The *accounting principles* are general decision rules, derived from both the objectives and the

theoretical concepts of accounting that govern the development of accounting techniques.

Riahi-Belkaoui's examples of principles are: cost principle, revenue principle, matching principle, objectivity principle, consistency principle, full disclosure principle, conservatism principle, materiality principle, uniformity principle, comparability principle.

The *accounting techniques* are specific rules derived from the accounting principles that account for specific transactions and events faced by the accounting entity.

5.2 Variations in use of terminology

Riahi-Belkaoui's exposition, taken alone, could give the impression that there would be no debate about the structure of a theory but the enquirer who moves on to explore further text books discovers very quickly that there is no agreement on the meaning of a 'principle' in accounting.

Kam (1990, p.43) points to the problems of distinguishing postulates from principles.

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Because in accounting we have not been able to prove logically that a given method is derived from certain principles, which in turn are derived from given first-level statements, there are disagreements about what level a particular statement belongs [to]. For example is 'going concern' a postulate or a principle? We must therefore depend a lot on intuition and our general understanding of accounting as to where and how different parts fit together.

An example of a postulate from Accounting Research Study ARS 1¹³² is:

Changes in assets and liabilities, and the related effects (if any) on revenue, expenses, retained earnings, and the like, should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms.

An example of a principle from Accounting Research Study ARS 3¹³³ is:

3. All assets of the enterprise, whether obtained by investments of owners or of creditors, or by other means, should be recorded and reported in the financial statements. The existence of an asset is independent of the means by which it was acquired.

There appears to be little difference in the generality of each of these statements. Both are concerned with recognition of elements of financial statements. It is important for accounting to understand when recognition takes place, but it is less important to debate whether this involves a postulate or a principle.

It might be thought that 'historical cost' is a strong principle of established accounting but Sterling (1967) argued that historical cost (he called it a 'rule') was nothing more than a manifestation of the principle of conservatism. Sterling disagreed with the principle of conservatism and

thus disagreed with historical cost, arguing instead for exit values.

Wolk Dodd & Tearney (2004, p.125) point out that the AICPA equated a principle with a rule:

*A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice...*¹³⁴

Resorting to contemporary sources from the 1950s and 1960s muddies the waters even further. Zeff (1982, p.1), in documenting the accounting postulates and principles controversy of the 1960s, opens with the statement that terms such as axiom, postulate, principle, standard, procedure, canon, and rule, among others, are widely used, but with no general agreement as to their precise meaning. He cites the report of the Council of the AICPA which said in 1958:

Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thoughts and customs of all segments of the business community. The profession, however, should make clear their understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations (Journal of Accountancy, Dec 1958, p.63)

Zeff continues by observing:

This usage of the terms is not consistent with the Accounting Terminology Bulletin No. 1 (pp. 10-11). The Terminology Bulletin (1953) stresses the definition of a 'principle' rather than a 'postulate', with principle defined as a 'general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice...' It then subordinates 'postulate' to

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'principle' by stating that 'initially, accounting postulates are derived from experience and reason; after postulates so derived have proved useful, they become accepted as principles of accounting'. The definition of postulates in the Terminology Bulletin is the same as the usage by the Study Group on Business Income in its report entitled Changing Concepts of Business Income (1952). That report singled out the monetary postulate, the permanence postulate and the realisation postulate.

Riahi-Belkaoui (2004, p.211) cites Littleton (1938):

Each book usually contains a mixture of axioms, conventions, generalizations, methods, rules, postulates, practices, procedures, principles and standards. These terms cannot all be synonymous.

Riahi-Belkaoui claims that his definitions (set out in section 5.1) solve this problem. Buckley *et al.* (1968) supported the sequence as being: (1) objectives (2) postulates (3) principles (4) rules.

Zeff (1971) found no improvement in the definition of a principle when he wrote

Some readers may be irked by the loose use of the term 'accounting principles'. In view of the diverse usages of the term among and within the five countries, it was impossible to give it a single, unequivocal meaning in this presentation. As much as possible, however, I have tried to distinguish between the measurement rules affecting asset valuation and income determination, and the form and extent of disclosure in financial statements. I have denoted the former, loosely to be sure, as accounting principles, and the latter as disclosure. While it is true that many would limit 'accounting principles' to mean the underlying premises and concepts, I have more often than not used the term, as have many practitioners, to encompass 'not only the

principles and practices but also the methods of applying them' (Accounting Principles Board Opinion No.6, para.7). *Where the more primitive, underlying propositions are intended, I have employed the modifiers 'fundamental' or 'basic'. (Zeff, 1971 p.vii).*

5.3 Meanings of 'principle'

In their text book Wolk, Dodd & Tearney (2004, p.125) offer a range of statements about the nature of a principle.

They cite the AICPA Accounting Terminology Bulletin No 1 of the AICPA (1953, pp.9505-9506) which defines a principle as:

A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice...

This definition is not particularly helpful to the 'principles versus rules' debate because it equates a principle with a rule. However it does bring out the ideas of generality, settled agreement and a basis for practice. Wolk, Dodd and Tearney (2004) cite two scientific explanations of the nature of a principle:

A law differs from a principle in that the former contains elements observable by empirical techniques, whereas the latter does not. If a principle could be empirically tested and if proven true (or at least not proven false), it would be capable of becoming a law. Caws, P, (1965) The Philosophy of Science (Van Nostrand) p.85-86.

Principles are general statements which influence the way we view phenomena and the way we think about problems.

Harré R, (1970) The Principles of Scientific Thinking (University of Chicago Press) p.206.

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5.4 Principles as a basis for radical change

Zeffer (1982) compiled a fascinating collection of papers illustrating the controversies that arose over two research studies published in 1961 and 1962. Maurice Moonitz (Director of Accounting Research at the AICPA) wrote Accounting Research Study No. 1 *The Basic Postulates of Accounting*, for the Accounting Principles Board (APB) of the AICPA in 1961. Robert Sprouse and Maurice Moonitz together wrote Accounting Research Study No. 3 *A Tentative Set of Broad Accounting Principles for Business Enterprises* in 1962. The APB declared that the conclusions reached in these two studies were too radically different from generally accepted accounting principles at that time.

What was so radical about the principles? In the summary of ARS No. 3 the authors wrote:

In accordance with the emphasis in the postulates study, this study of broad principles takes the position that ideally all the assets (and liabilities) should be recognized, as well as all changes that can be objectively determined. In addition to those changes which result from explicit transactions with other entities, this study recommends the recognition of price-level changes, of movements in replacement costs, and of changes from other causes, again provided that the evidence is objectively determinable (ARS No.3, Ch.7).

The members of the AICPA's advisory committees on the projects for ARS 1 and ARS 3 did not take well to these radical notions. Their critical comments are published with the studies.

... indiscriminate application of the principles could result in false and misleading financial statements and might tend to undermine the confidence of the public in all published financial statements (Andrew Barr);

The idea that plant and equipment should be restated ... is an old and discarded idea with only a slight new twist (Carman Blough);

... publication of the research study will serve no useful purpose and likely will delay development of the broad principles comprehended in generally accepted accounting principles (Oscar S. Gellein);

... it seems clear that the Institute has the responsibility of establishing an inventory of current generally accepted accounting principles before, or at least separate from, undertaking substantial changes (Paul Grady);

... the accounting principles presented are neither adequately supported nor successfully defended; this becomes evident when, with respect to each, the simple question is asked "why?" (Leonard Spack);

I am extremely fearful that, in the way in which the document has been prepared, there is an inadequate distinction between practices which have received general acceptances to data and those which you propose as additions to or changes in existing practices (William W. Werntz);

... this study contributes very little to establishing a foundation which may be used by the profession in narrowing the differences of opinion that exist in practice as to what constitutes generally accepted accounting principles (John H. Zebley, Jr.).

There was one voice of support

This tentative statement of accounting principles is an excellent job (Arthur M. Cannon).

The intensity of debate over ARS 1 and ARS 3 did much to equate the concept of a principle with the concept of current value measurement so that what began as a debate over principles turned into a debate on valuation.

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5.5 Attitudes in the profession

In another fascinating study Zeff (1971) traced the history of development of principles up to 1970 in five countries: England, Scotland, Mexico, United States and Canada. In his concluding chapter he says:

Among the knottiest problems of all, one that has driven Moonitz to despair, is how to bring basic or fundamental accounting principles into the mainstream of a pronouncements program.

He suggests reasons for the poor record, at that time, of basic principles in research and pronouncements programmes. (Pronouncements were the predecessors of accounting standards.) His analysis was:¹³⁵

1. Practices have grown up in such different economic environments over time that it would appear to be impossible to make any instructive generalisations about accepted practice.
2. The traditional lack of attention that accountants have devoted to the premises and objects of their work, together with a lack of agreement in the academic literature on the underlying propositions, requires that any prescriptive study on the subject begins at zero, a difficult undertaking for any investigator.
3. There is a skepticism among practitioners about the benefit to be gained from devising a conceptual framework as the basis for generating 'sound' accounting principles. They may also feel threatened by the prospect of having to learn to work with the novel practices that might emerge from such a logical exercise.
4. Practitioners, who are all too conscious of the bewildering diversity that populates the

'real world', are exceedingly reluctant to generalise at a plane where variety would be de-emphasised in favour of regularities and patterns, if not apparent sameness, in the circumstances to which accounting principles would be applied.

Zeff concluded that the problem confronting the profession in regard to basic principles and research was not solely one of knowledge but also of attitude.

5.6 SEC view on rules, prior to Enron

The SEC had focussed on the limitations of rules-based standards prior to Enron. In 2001 Lynn Turner, as Chief Accountant to the SEC, referred to a speech by the Chairman in 1975:¹³⁶

In the area of encouraging registrants to disclose additional useful information, I find the remarks made by Ray Garrett when he was Chairman of the SEC in a speech he gave in 1975 to be equally instructive today, and I quote him as follows:

I should point out that in general, we have not found registrants and their accountants and lawyers anxious to develop innovative and experimentive approaches in filings with the Commission. Financial statements and other disclosure documents have been too often approached from the viewpoint of limiting liability rather than providing information. This has led to a desire for rules that can be followed in contrast to statements of objectives to be achieved.

Turner attached some blame to the lawyers:

The conspicuous failures of accounting in recent years, such as leases and business combinations, are areas which are characterized by an excess of rules and a minimum of reason. I also regret

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to say that these are also the transactions most characterized by the presence of attorneys, whose task is to document transactions so that they conform to detailed rules and, hence, are eligible to be accounted for in a fashion contrary to their essence.

Lynn Turner continued with his enthusiasm for the words of Chairman Garrett. Turner did not reject rules – he wanted high quality rules and integrity in application of the rules. The emphasis in the following quote is that of Turner:

In the final analysis, it seems to me that rules are a necessary part of financial disclosure and that it is only fair to allow people to predict accounting outcomes of transactions at the time they are entered into. On the other hand, it is not reasonable to expect that rules will serve as an immunization against the obligation to reflect reality in financial statements. Rules, therefore, can only be regarded as a minimum. Good information for investors requires good will and good sense as well as good rules. (emphasis added) (Ray Garrett, Chairman of SEC, in speech: The Need for Change in Accounting Policies, 1/6/75).

I could not agree more with former Chairman Garrett's remarks about the need to have good sense and good will - by that I mean, integrity -- toward investors in addition to good rules. It is the sensible, good faith application globally of high quality accounting and auditing rules, that makes all the difference in the world.

In 2000, Chairman Arthur Levitt appeared to take a contrary view in comparing principles and rules for the audit profession. However, while supporting principles he also supported 'bright line' rules:¹³⁷

Many in the profession once sought to establish broad "principles" of independence.

While principles may sound "high-minded", the lack of precision may not address the level of uncertainty as to which services are permissible and which ones are not. A public disclosure-based model, already used in the UK, could be worthwhile for certain types of perceived conflicts if such disclosure doesn't devolve into meaningless boilerplate.

Perhaps a more reliable way to safeguard independence would be to clearly define those consulting services that compromise the integrity of the audit without adding meaningful benefits to that audit. Like any rules, however, such an approach entails a degree of definitional precision.

While a "perfect" solution may not exist, that's no reason to sit back and do nothing. A careful balance of "bright line" rules establishing clear limits, coupled with greater disclosure, seems both warranted and prudent. But, even before the SEC considers ways to safeguard independence, I appeal to corporate America's audit committees to pay close attention to the types of services their auditors are performing and to question whether it would be more in their investors' interests to have some of those services performed by someone else.

5.7 Overview and comment

An example of a scientific principle is Le Chatelier's principle of equilibrium which states:

Any change in one of the variables that determines the state of a system in equilibrium causes a shift in the position of equilibrium in a direction that tends to counteract the change in the variable under consideration.

This observation applies to chemical reactions, physical states, and many situations of sociological and economic experience. It is supported by

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a large amount of scientific research, it can be reasoned through mathematical logic, and it has a strong intuitive appeal.

This kind of well-supported principle is probably what many commentators have in mind when they call for principles-based accounting. The difficulty in accounting is that there are very few principles that would command such widespread support. The experience of the 1960s was that the extent of disagreement with specific principles tended to grow in direct proportion to the effort expended in defining those principles.

Wolk, Dodd and Tearney (2004, p.148) are of the opinion that the 'postulates and principles' approach had, in essence, died out by 1970. They attribute this to the failure of the Accounting Research Studies ARS 1 and ARS 3 and the difficulty of building on a postulate base. The demise of the Accounting Principles Board (APB) was one of the reasons; the failure of the APB had other causes but the APB was identified with postulates and principles and so its decline was a signal that postulates and principles were obsolete as theoretical underpinnings.

New developments, particularly the Trueblood Report and the establishment of the FASB, turned attention in the US to user needs, diversities and the objectives of financial statements. The UK developed a standard-setting process (from 1970 the profession-based Accounting Standards Steering Committee, becoming the Accounting Standards Committee and, from 1990, the independent Accounting Standards Board) with a user-needs orientation. The user-needs orientation is most clearly evident in *The Corporate Report*¹³⁸, issued in 1975 by the Accounting Standards Steering Committee. The language of *The Corporate Report* is based on the terminology of objectives and concepts. Under the heading of 'concepts' there is discussion of accruals, prudence and bases of measurement. These issues would have been discussed as 'principles' ten years earlier.

SECTION SIX - CONVERGENCE, COMPARABILITY, CONSISTENCY AND CULTURE

This section covers convergence, comparability, consistency and culture as four issues that pervade any debate on 'principles versus rules'.

Convergence is the current aim of the International Accounting Standards Board:¹³⁹

The Board's main thrust is now on achieving the convergence of its standards with those of other standard-setters, and particularly those of the FASB. We have been told repeatedly by multinational companies that this must be our most important objective.'

This section shows more of the thinking in the US about the meaning of convergence from a US GAAP perspective. This focus on convergence has implications for establishing acceptable principles as a basis for setting converged accounting standards.

Comparability and consistency have already been cited in section 2 as bases for arguments for and against rules-based standards. This section brings out further aspects from the US perspective that may be relevant to the process of convergence.

Finally this section provides a reminder that there is a significant body of academic research on the extent to which cultural differences cause different accounting practices to be operated. Any process of convergence that is truly global needs to take account of the strength of these cultural pressures.

6.1 Convergence

6.1.1 SEC views

In 2002 Robert Herdman commented on convergence issues in a speech in Germany to the Schmalenbach Institute for Business Administration.¹⁴⁰ First he explained the strengths of the US system:

In the United States, it is typical that the largest national audit firms maintain an internal quality control mechanism that includes a

centralized system where the interpretation and application of US GAAP is controlled by a group of technical experts that specialize in specific topical areas, such as business combinations, leasing or financial instruments. In the US, achieving consensus on application and interpretation is generally an efficient and timely process. This is mainly attributed to three factors. Perhaps the most obvious: US GAAP is the product of a standard setter from one country. Second, the application of US GAAP is made predominately by professionals within one country. Lastly, most accounting professionals are trained in US GAAP during their college education. In addition, the role of the Emerging Issues Task Force or EITF in the consistent application and interpretation of US GAAP cannot be overemphasized.

Then he contrasted the challenges of implementation in Europe:

In contrast, the application of IAS by European professionals has the potential to be much more challenging. Not only is there the mere fact that the standards will be applied by professionals in at least 15 different countries, as most of you know, IAS is a set of high-level standards based on very general principles, which in many cases lacks sufficient application guidance. I am not advocating that the IASB abandon its principle-based approach. Application guidance can be principle based as well. This is in contrast to the rules-based standards that have been issued by the FASB in recent years, for example SFAS No. 133 and 140. However, having high-level, principle-based standards could create an issue on how to address the potential differing interpretations that can arise when the standards are applied in practice - not only by professionals from different countries, but also professionals from different audit firms, and in an environment of extensive and immediate change from practices these professionals have followed during their entire careers.

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Herdman reinforced the concern for multiple interpretations by urging a mechanism in the EU to encourage consistency in interpretation and application:

All of us will want to avoid the emergence of multiple interpretations of IAS for identical transactions not only within the EU, but also between the SEC staff and practitioners in the EU. A significant amount of work would seem to be necessary to create a mechanism within the EU to ensure the consistent interpretation and application of IAS by European issuers. In that vein, I am very much aware of this issue and encouraged that issues are expected to be brought to the International Financial Reporting Interpretations Committee or IFRIC for consideration. While I believe IFRIC will be an important element of the infrastructure, the audit firms and European regulators must also play a key role in creating an environment where consistent interpretation and application can flourish.

Almost identical wording was used by Chairman Harvey Pitt in October 2002 in Brussels, addressing a conference of the Institute of Chartered Accountants in England and Wales.¹⁴¹

Deputy Chief Accountant Scott Taub explained the concern of the SEC as a regulator to develop 'processes' to reduce the potential for multiple interpretations:¹⁴²

In addition, if the IASB is to maintain its policy of keeping its standard at a fairly high "principles-based" level - with less detail than might be the norm under US GAAP, for example - it will be true that for some issues, the standard-setter will not provide guidance. If, in the absence of guidance from the standard-setter, the securities regulators are to accept any interpretation, investors will be subject to multiple conflicting applications, some of which

may not provide transparent information. As a regulator, I do not find this to be acceptable, and I don't believe many other regulators would either.

So we will be in the position of making decisions regarding interpretations of the standards. With the same or similar standards being used in so many jurisdictions, there is the possibility that different regulators will have different views on the correct application of a standard. That type of situation would be detrimental to the capital markets, and would, of course, undo some of the gains of convergence in standards. To mitigate against this possibility, regulators are working to develop processes that would encourage consultation amongst regulators, thereby reducing the chances for multiple interpretations.

Harvey Pitt in February 2002¹⁴³ saw a need for transformation in the accounting profession.

We also need to ensure that auditors and accounting firms do their jobs as they were intended to be done. Our disclosure system depends on it. And yet, long before Enron's collapse, it was painfully clear that the accounting profession had experienced an enormous brain drain; the numbers of new graduates seeking to enter accounting, especially those at the top of their classes, were diminishing rapidly. The current environment - with its scrutiny and criticism of accountants - is unlikely to create a groundswell of interest on the part of top graduates to become auditors. Quality, quantity, competence and ethics have been, and still are, the key issues for the profession. We intend to deal with those issues, and help transform and elevate the performance of the profession. The profession we envision - with better fraud detection, accounting standards and oversight - will be vibrant and attractive to smart young people.

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Pitt appeared to have confidence that these smart young people would use their intelligence for good.

In December 2004 Andrew Bailey, the deputy chief accountant, also had views on how the profession would need to change if objectives-based standards were to be operated effectively:¹⁴⁴

We continually hear about the desire, on the part of all parties involved, for more principles based standards, in auditing as well as accounting standards. Principles based standards only work if everyone is committed to complying with the objectives of the standards, rather than using the language of the standards themselves to structure around the requirement. This change in mindset requires a cultural shift, and a significant one at that, before objectives based standards can be truly operational.

Bailey commented on the role of the auditor:

Principles based accounting standards will not work unless management and the audit committee apply the principles, not just comply with the rule. The auditor's contribution is limited by the accounting standards and the preparers' actions. The precision of the audited numbers is bounded by the precision of the underlying accounting standards and in situations where fraud occurs and is concealed by multiple parties; it can be hard to catch no matter what actions the auditor takes.

6.1.2 IASB

By 2004 Sir David Tweedie was complimenting the SEC and FASB on their initiatives towards a more principle-based approach.¹⁴⁵

Convergence with an international approach will inevitably raise the questions of rules versus principles in the United States. I note

that both the SEC and the FASB have already done some excellent research of the possibilities and consequences of adopting a more principle-based approach. Internationally there is a clear desire to maintain a more principle-based approach to accounting. In the United States, I sense a similar desire to reduce the complexity and sheer volume of accounting literature. That will not be easy and may take time to evolve, but I believe the benefits of such an approach will help reduce the complexity of US standards and improve accounting in general. Of course, the issue is not black-and-white, and there will always be a need for some explanatory guidance for the principles. But in promoting international convergence, we are determined to focus on crafting principles that are sufficiently clear to make detailed rules unnecessary.

6.1.3 A big 4 firm

In 2002 the global head of PwC, Sam DiPiazza,¹⁴⁶ called for the creation of principles-based global GAAP, and rejected the rules-based US model. He argued that the principles-based approach, exemplified by UK GAAP and International Accounting Standards, was the best foundation for making financial reporting more relevant to investors. He advocated a new model of information reporting by companies that communicated a holistic view of the enterprise - its marketplace opportunities, its strategies, its value drivers, and its financial outcomes.

In describing his view of global transparency¹⁴⁷ Di Piazza recommended three stages. Global GAAP would give comparability across countries. Industry standards would give comparability across industries. Company-specific information would give management's view of the company and its environment. In responding to a question about criticisms of US GAAP he said:

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International Accounting standards are more principle-based but the real answer should be a convergence of US and international standards that are robust yet based on guiding principles. We would like to see an entirely new set of standards emerge that are truly global in nature, we call this Global GAAP. This would allow for investors to compare the performance of any company in any industry with any other in any country of the world.

6.1.4 Europe

In January 2004 FEE launched a Discussion Paper entitled *European Enforcement Coordination*.¹⁴⁸ In that paper FEE called for the creation of a European coordination body to enforce IFRS, with a key role for CESR, the Committee of European Securities Regulators. The FEE President hints at global interpretations, presumably seeing a role for FEE. The FEE President David Devlin added:

With the launch of this paper FEE, the representative organisation of the European accountancy profession in Europe, is again underlining its strong commitment to high quality, principles-based, financial reporting standards. For reasons of competitiveness, comparison and capital raising, global financial markets require financial information that is prepared in accordance with global standards and global interpretations.

A market view from the regulator in France is quoted in Tunick (2003):

"I am quite optimistic we will be able in the next few years to really build a kind of international regulatory architecture with common standards, and I very much welcome the idea that we should work internationally, converge conceptually and base our developments on mutual recognition," said Michel Prada, who will soon head up the Autorité des

Marchés Financiers-France's newly created regulatory body for its financial markets. *"But there has been a problem of due process and extreme views on some specific issues such as financial instruments, and I believe that we have to negotiate to come to some more practical solutions."*

This extract points to the idea of convergence in terms of mutual recognition rather than convergence in terms of uniformity.

A strong warning on convergence was given by the European Commissioner, Charlie McCreevy, in December 2005:¹⁴⁹

What do we actually mean by 'convergence'? ... Although traditionally convergence has concentrated on the US GAAP- IFRS axis, we should not forget that today, convergence is not just limited to US GAAP. Other important and major jurisdictions are also seeking to more closely align their national accounting standards with IFRS and engage in fruitful cooperation with the IASB The convergence exercise must be a two way street and it must not be allowed to destabilise the IFRS platform in Europe. I would like to stress that convergence is not an invitation to standard setters to try and advance the theoretical frontiers of accounting The main objective is to try to narrow the differences between the existing standards, not to make accounts even more indigestible with a whole set of new standards.

There are two messages here. One is that convergence is something more than aligning IFRS and US GAAP. The other is that convergence should focus on the standards in their current state, rather than attempt major change at the same time as convergence.

Auditor independence is an area where there is also a 'rules or principles' debate because there is an interest in Europe in achieving convergence of auditing standards. Enforcing regulation is a matter for the jurisdictions of the separate

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member states but convergence is more readily achieved if all member states accept measures agreed at EU level. In particular the European Commission had agreed a recommendation on auditor independence in 2002. David Devlin of FEE¹⁵⁰ commented on this in 2004:

The accounting profession is calling on legislators to support the principles-based “threats and safeguards” approach to independence as agreed in the European Commission’s Recommendation on auditor independence of 2002. This combines universally applicable principles with relevant guidance, restrictions and prohibitions in a rigorous way. We think it is difficult to explain or justify in a single market why member states find it necessary explicitly to reserve the right to add measures beyond those agreed at EU level.

It would be in the interests of the European Union to encourage principles-based standards because member states might find it more difficult to disagree with the principles. If they were allowed to add detailed rules then they might seek to undermine the principles so a restriction on additional measures would encourage convergence.

A FEE position paper¹⁵¹ on auditor independence rehearsed the advantages of a principles-based approach to auditor independence:

By focusing on the underlying aim rather than detailed prohibitions, the principles-based approach combines flexibility with rigour in a way that is unattainable with a rule-based approach. In particular, it:

- *allows for the almost infinite variations in circumstances that arise in practice;*
- *can cope with the rapid changes in the modern business environment;*

- *prevents the use of legalistic devices to avoid compliance;*
- *requires auditors to consider actively, and to be ready to demonstrate the efficacy of, arrangements for safeguarding independence, especially in relation to relationships or proposed services which are not specifically prohibited or restricted.*

Goran Tidström, President of FEE, made the distinction between standards and enforcement, in relation to auditor independence, in a letter to Director General of European Commission, 26 September 2002:¹⁵²

The work of the EC Committee on Auditing on auditor independence started long before the issue was raised in the US. Because it is principles-based, the EC recommendation would have covered situations that have been criticized in the US. We strongly believe that a fundamental ethical issue cannot be adequately dealt with solely through rules and prohibitions. If something additional needs to be done in the EU in relation to auditor independence, it is in the area of enforcement. For that reason, one of the priorities now is to strengthen and harmonise the established European Systems of oversight covering enforcement of independence.

6.1.5 Australia

In a joint press statement on 27 June 2002, the Treasurer and the Parliamentary Secretary to the Treasurer announced a process for achieving further improvement in audit regulation and the wider corporate disclosure framework as the next phase in the Government’s Corporate Law Economic Reform Program (CLERP).¹⁵³ The Introduction to that document acknowledged the global impact of Enron and related US cases:

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The final implementation of reforms will need to take account of any relevant recommendations of the HIH Royal Commission, work being undertaken by the Joint Committee of Public Accounts and Audit (JCPAA), and developments overseas. The United States has recently introduced significant legislative reform in the area of corporate disclosure in response to the Enron collapse and the overstatement of earnings by WorldCom and certain other large corporations.

The globalisation of markets means that, in adjusting its regulatory framework, Australia must have regard to developments in major economies. Australian companies will face a cost of capital premium if our framework is perceived to be less rigorous than elsewhere, and they will pay a compliance cost penalty for over-regulation or poorly conceived regulation. In either case, their international competitiveness may be impaired. The objective must be for Australia's regulatory framework to remain in line with or ahead of world's best practice.

6.2 Comparability and consistency

6.2.1 Similar treatment for similar transactions

Schipper (2003, p.62) explains her view that the desire to achieve comparability, and its counterpart over time, consistency, is the reason to have reporting standards. If similar things are accounted for in the same way, either across firms or over time, it becomes possible to assess financial reports, across firms or over time, so as to discern the underlying economic events. If little value were attached to having the same accounting treatment applied to identified classes of similar items, then preparers of financial reports could be left to choose the reporting that best suited their own communication strategies. If it is agreed that comparability is desirable, then relevance and reliability assist in deciding which standards

to have. Her conclusion from this analysis is that, to the extent that US GAAP is aimed at providing comparable, relevant and reliable financial reporting, it is principles based.

The view of consistency as 'similar treatment for similar transactions' is seen also in a speech by Chief Accountant Donald Nicolaisen in September 2004:¹⁵⁴

I also believe that the current process of accounting standard-setting can be improved by focusing more on the underlying objective of the accounting that is being addressed. Similar transactions should receive similar accounting. While both the IASB and the FASB do identify key principles and objectives, further work is still needed to better clarify the principles underlying all existing standards. This will not be easy.

Commissioner Glassman, speaking to business economists, weighed economic reality against comparability:¹⁵⁵

I believe such an objectives-oriented system would give companies and auditors the ability to deliver numbers grounded in economic reality, while providing the comparability the market needs.

This interpretation could be seen as leaving more latitude but may reflect the composition of the audience for the speech .

6.2.2 The need for guidance in comparability and consistency

Extracts from SEC speeches in section 3 showed that the SEC reined in its enthusiasm for unfettered principles-based standards as the risks of allowing judgement became more apparent. In July 2003, Commissioner Cynthia Glassman addressed the Exchequer Club:¹⁵⁶

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Should we decide to pursue a more principles-based approach, there are, to be sure, some significant issues that will have to be addressed along the way. For example, we need to make sure that the principles are not so broad that they fail to provide enough guidance to those who prepare and audit financial statements. In addition, the principles must be sufficiently well defined so that they can be applied in a manner that allows for comparability across companies. I don't think anybody envisions that "principles-based" means loose rules that give unfettered discretion, but deciding how much detailed guidance to provide can be more art than science.

If it is envisaged that guidance is required then being in charge of the guidance becomes an important role. Barry C Melancon, President of AICPA and William F Ezzel, Chairman, responded on behalf of the AICPA to the FASB 2002 proposals:¹⁵⁷

The AICPA supports a movement towards principles-based standards. We believe that such a movement is needed to ensure that financial statements are faithful representations of economic activity and thus that financial statements continue to be relevant tools for making investment, credit, and other decisions. We believe, however, that the Board needs to do more work defining the essential elements of the new model standard. Without identification of those essential elements, the Board's constituents may not fully understand how the Board intends to achieve the goals and objectives outlined in the proposal and, ultimately, consistency in standard setting will be difficult to achieve.

The AICPA gave warnings on matters that would need to be considered in setting principles-based standards:

We recognize that the setting of standards in this undertaking will require the Board to balance

competing needs. Among the needs that the Board should consider are the following:

- 1. The need for comparability of financial statements*
- 2. The need to understand the litigious and regulatory environment in the United States*
- 3. The need for industry-specific guidance*
- 4. The need for implementation guidance*
- 5. The need for an appropriate transition*

Comparability would be difficult to achieve if the principles were too general. The AICPA urged that principles be set at a level that would indicate the standard-setter's expectations. The AICPA was concerned that the plethora of regulators interested in accounting might create rules that would curtail the effectiveness of a principles-based approach. The AICPA offered itself as the most suitable body to provide industry-specific guidance. Implementation guidance would be inevitable – if not provided by the FASB then it might come from profession-wide or commercial sources. Transition from rules-based to principles-based accounting would have to be explained.

The perception of the European Commission on consistency was set out in a speech by the European Commissioner, Charlie McCreevy, in December 2005.¹⁵⁸ He outlined the proposals for a temporary, informal Roundtable involving a range of relevant stakeholders who could gather diverging national and local interpretations on guidance given on IFRS. The Roundtable would not be making any interpretations. Issues would be taken to IFRIC for interpretations. Also the Roundtable would not be used as a platform to review decisions taken by enforcers.

6.2.3 Real and apparent comparability

Despite her initial explanation that comparability means that similar things are accounted for in the same way, Schipper (2003,

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p.67) gives a warning on the distinction between true comparability and apparent comparability, which she calls 'surface comparability':

One alleged benefit of detailed implementation guidance is increased comparability. That is, specific guidance on how to apply a standard should reduce the effects of differences in professional judgement. But to the extent that the guidance is inappropriately strict, the result will be surface comparability and dissimilar arrangements will be forced into the same accounting treatment. It is not clear whether increasing the amount of detailed guidance increases this risk.

She points out that there are considerable problems in devising an experimental measure of comparability, with the result that there is no objective measure of the existing level of comparability that could be compared to the effects of any proposed change.

6.3 Culture

'Culture' is the description of a set of common ideas, beliefs and values that are shared by the members of a group of individuals. In the sphere of accounting research a great deal of work is based on the definitions of Hofstede, an organisational psychologist. He defined culture as 'the collective programming of the mind which distinguishes the members of one human group from another'.¹⁵⁹ Culture may be influential in concluding whether a rule-based or a principles-based accounting framework would be the most appropriate.

6.3.1 Academic studies

Hofstede (1980) reported the largest study conducted into the culture of nations and countries, with over 110,000 respondents to a survey conducted in the 1960s. Results were

compiled for each country based on pairs of contrasting cultural dimensions as:

Individualism *versus* collectivism
Large *versus* small power distance
Strong *versus* weak uncertainty avoidance
Masculinity *versus* femininity (probably better described today as low *versus* high nurture).¹⁶⁰

Hofstede's measures show relatively similar scores for the US and the UK and imply that in both the US and the UK individuals focus on the welfare of the individual and their freedom of choice. They are willing to take risks and they believe that people should have equal relationships.

Gray (1988) applied Hofstede's cultural dimensions to accounting and proposed four pairs of contrasting accounting sub-culture as:

Professionalism *versus* statutory control
Uniformity *versus* flexibility
Conservatism *versus* optimism
Secrecy *versus* transparency

Gray classed both the UK and US under the heading 'Anglo' with a preference for professionalism, flexibility, optimism and transparency. He contrasted this with preferences for secrecy, uniformity and statutory control in continental European countries and others. Gray's classifications are probably out-of-date today but the framework of analysis remains useful in considering the cultural background to accounting differences.

Baydoun and Willett (1995) suggested that differing levels of accounting information are more likely to be influenced by culture. Hussein (1996) pointed out that the FASB in 1978 acknowledged the potential influence that culture may have upon the economic, legal, political and societal environments in which accounting legislation is set.

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Roberts and Salter (1999) explored the attitudes of auditors in international accountancy firms across 23 countries towards rules mandating a single treatment across 14 issues. They found that auditors were generally in favour of a single treatment but the extent of support depended on the culture and the importance of the stock market of the country. As stock markets increased in importance, auditors preferred to see a reduction in accounting choices. Individualism was associated with less support for uniformity.

Jakubowski *et al.* (2002) analysed ethical codes across eight countries. They found some commonalities that could constitute evidence that ethics are culture-free but they also found differences in the codes which they attributed to cultural factors. Chanchani and Willett (2004) surveyed accounting values in New Zealand and India in the mid-1990s and found support for Gray's classification. Want (2003) claims that culture impacts on every aspect of organisational performance.

Jackson (2004) quotes a professor of auditing at the University of Zurich, Switzerland, emphasising the history of different countries and their different legal structures. He contrasts the investor emphasis in the US and UK with the creditor protection regimes of continental Europe. These lead to different forms of governance with the result that principles must take precedence over rules. Jackson also quotes the head of corporate audit of a business conglomerate based in Mumbai, India. The auditor supports a principles-based approach even though it may be confusing at first and may leave compliance open to variations in interpretation. He also notes that companies may follow what is written rather than actually understand the principles involved.¹⁶¹

6.3.2 Comments in the US

Taking the narrower view of culture within a country, the culture of financial reporting was a concern for Chairman Arthur Levitt in 2000:¹⁶²

...it's become increasingly clear that the essence of our misgivings about the state of financial reporting rests not in a particular disclosure or sales practice or single accounting technique.

Rather, it's an emerging culture rooted more and more in a particular way of thinking; an approach guided by short-term expectations and, quite frankly, driven by an imperative to exceed them. It seems that what really matters in the marketplace is being obscured by a culture, in some respects, almost overtaken by the very drive and optimism that first gave it life.

In the past, I've referred to this mindset as a "culture of gamesmanship". A mindset that says "if a competitor is testing the limits of appropriate conduct, then so can I". If a rule doesn't expressly prohibit it, then it's fair game. If someone isn't playing the game, well then, they just don't get it.

Too many CFOs are being judged today not by how effectively they manage operations, but by how they manage the Street.

The FASB pointed out that a change in culture was needed to make a principles-based approach effective:

The Board emphasizes that, if adopted, a principles-based approach to standard setting would require changes in the processes and behaviors of all participants in the US financial accounting and reporting process, not just the FASB and other standard-setting bodies. Thus, in order for that approach to work, all participants must be equally committed to making those changes ...

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... Preparers and auditors would need to apply professional judgement in more circumstances, while the SEC, investors, creditors, and other users of financial information must accept the consequences of applying professional judgement, 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 judgement in more circumstances. The ability of the SEC to address those concerns will be critical in order for a principles-based approach to work.

In addition to the dimensions proposed by Hofstede and Gray, there are other cultural factors to bear in mind when considering the suitability of either a rules-based or a principles-based accounting system for the US. One of the most important is the highly litigious environment of the US. It is widely accepted that the nature of the legal system in a country influences its accounting practices (eg. Salter and Niswander, 1995). Due to the volume of litigation in the US, it would be reasonable to suspect that practitioners might be reluctant to increase the level of professional judgement applied, for fear of subsequent lawsuits.

The culture identified in the US, and similarly the UK, points to the importance attached to equality and fairness. Whether rules or principles achieve those aims better is a matter for further debate. What is clear is that culture has an important role in the debate regarding a rules-based or a principles-based approach to financial reporting. A culture affects the way that its members think, feel and act and it thus has the potential to greatly influence the success and applicability of the chosen financial reporting framework.

6.4 Overview and comment

Convergence, consistency and comparability all lie on a range of meanings. At one end of the spectrum there is total uniformity where all transactions and events of a similar type are reported using a single procedure in a defined manner. At the other end of the spectrum there is a range of treatments of transactions and events of a particular type. The selected treatment is explained and justified in such a way that those seeking to make comparison understand the nature of any difference from other treatments that might be applied. Both ends of the spectrum can be said to achieve convergence, consistency and comparability because there is harmony across the range; the stated treatments, although different, are applied consistently in comparable circumstances; and there is full disclosure of the treatment selected. However those who use these words tend to have their own preconception based on only one location within the spectrum.

Studies have shown that culture, as a system of beliefs shared by a group of persons in society, can be seen as explaining aspects of accounting differences. In particular, Gray (1988) has developed a model for linking accounting values to cultural values which seems to have continuing relevance as a framework for analysis. The evidence points to the conclusion that any attempt to enforce a uniform system of principles-based accounting standards may encounter different levels of support or resistance in different countries because of cultural traditions.

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Nearly every area of human activity, and certainly every area that involves social interaction, is, to a greater or lesser extent, rule-governed. We often assume that to understand something is to understand its rules – that we know how to play a game, speak a language, make a measurement, or calculate an integral if we know how to follow the rules relevant to these activities. We may even regard these rules as definitive of the activities in question, believing, for instance, that to measure *is* to follow a set of operational measurement procedures, and that no further definition is required, or even makes sense.

And yet the business of ‘rule following’ itself cannot be understood in this way. If we did not know how to follow rules, then an exposition of ‘rule following’ in terms of the rules which govern ‘rule following’ would be useless. In some sense, ‘rule following’ is a piece of fundamental human behaviour which defies further analysis of this kind. Since the business of analysis itself is carried out in a very sophisticated rule-driven context – the context of language use – we should not be surprised that any explanation we might attempt could not be more fundamental than the business of ‘rule following’ itself.

How should we understand ‘rule following’ in general, then, and how is this relevant to particular cases of social ‘rule following’?

7.1 Wittgenstein on Rules

Philosophical interest in ‘rule following’ really starts with the various discussions of rules that appear in the later writings of Wittgenstein – particularly: Wittgenstein and Anscombe (1958), Wittgenstein, Anscombe *et al.* (1974), Wittgenstein, Anscombe *et al.* (1978) and Wittgenstein and Diamond (1989).

The examples of rules that Wittgenstein produces in his discussions are mainly examples of mathematical or logical rules. His mathematical examples focus on rules for continuing a series

indefinitely – *eg.* determining what comes next in the sequence ‘1,3,5,7 ...’. The principal outcomes of these discussions are as follows:

- (1) We cannot understand ‘rule following’ *in general* by seeking the rules that underlie it.
- (2) Cases of ‘rule following’ can only be understood in terms of, and possibly from within, the ‘form of life’ within which they are embedded.

In addition to these two points, Saul Kripke provided an interpretation of Wittgenstein’s position that had a wide influence, although it was disputed (see McGinn 1987). Kripke observed that:

- (3) No finite number of observed cases of ‘rule following’ can uniquely determine the rule that they instantiate.

This section explicates some of these outcomes and considers those circumstances where adjudication is required. For example, suppose there is a need to decide a difficult case of conformity. While a philosopher may point to essential ambiguities, a court must actually establish a verdict.

Wittgenstein’s exposition of problems in ‘rule following’ often focuses on a sort of ‘insight’ event where the student suddenly ‘sees’ how the rule should work, and thereafter is able to follow it. Learning to count by threes, for instance, is simply the ability to continue the series ‘3, 6, 9, 12 ...’. While one might *ask* for further explication of this, further explication will not give any better demonstration of the student’s understanding than does the simple capacity to follow the rule. Many areas of human activity depend upon following rules that are not fully explicated. To be able to speak is, at least partly, to be able to follow grammatical and other linguistic rules - rules that many competent speakers cannot

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articulate. We *may* be able to articulate, or further explicate, these rules but clearly the capacity to articulate the rules cannot precede our capacity to talk in the first place. Our ability to follow a rule underpins, rather than depends on, our ability to articulate one. The Wittgensteinian moment of insight might be represented as the state we are in while we can follow a rule without being able to articulate it.

For Wittgenstein it appears that, while we might ask questions about how to follow a rule, these questions come to an end at some point. This ending occurs with a practical recognition of understanding rather than with a final 'foundational' set of answers. We either can or cannot follow the rule, and we demonstrate this in our actual practice (for instance, we know how to continue the arithmetic series). The 'ground' for all of this is the 'form of life' within which this practice takes place, and within which we play our 'language games'. Questions about this ground itself are, in effect, questions about whether the language game is possible – they are questions about whether it is possible to ask questions.

Kripke (1982) and Hart (1994) are controversial interpreters of Wittgenstein. They provided critical interpretation (exegesis) and offered constructive aspects which are described here.

Kripke argued that there is no empirically conclusive method for determining whether a person's past behaviour conforms to a rule. This is because there are always mutually contradictory rules to which any list of past events can be said to conform. His classical example is the rule of addition: We might imagine that we can always determine whether someone is adding up. Imagine, however, a number i larger than any result of human addition to date. Now consider the rule for 'quaddition': Quaddition gives the same result as addition except when that result is larger than i . In cases where the result of addition is greater than i , quaddition

gives the result 57. Given the definition, there is no way of determining, for any apparent past case of addition, whether it was not instead a case of quaddition and whether the quaddition rule was consistent with the addition rule.¹⁶³

The arguments of Wittgenstein and Kripke show that there are conceptual limits to what can be done with rule-based systems. Mackenzie (2003) has drawn attention to the possible relevance of Wittgenstein's approach to an ethnographic understanding of the accountancy profession's reaction to the Enron collapse. However, the problems generated by such conceptual limits should not be overstated – after all, mathematicians have known since the 1930s (Chaitin 2004, Gödel 1962, Turing 1936) that complete 'rule-based' (axiomatic) reconstructions of mathematics are not formally possible. Nevertheless this has not undermined the usefulness of limited formalistic approaches to many branches of mathematics. Wittgenstein clearly regarded basic mathematics as a useful source of examples of unproblematic 'rule following'.

7.2 A jurisprudential perspective

Jurisprudential discussions of 'rule following' may be more relevant to practical disciplines, because they concern themselves more with real contexts of adjudication.

Hart (1994) was an advocate of what has been called 'legal positivism' – the view that what the law is can be decided on the basis of certain social facts. His positivism should be distinguished from that of the Benthamite (Bentham, Ogden 1987, Hart 1982) positivist John Austin (Austin and Campbell *et al.* 1869, 2004), for whom the relevant 'facts' were the commands of the sovereign. Hart pointed out that this earlier account is unable to distinguish sovereign coercion from 'illegitimate' coercion (*eg.* an instruction from an armed criminal). For Hart, the social facts that determined what became the law were acts of a

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legislature and those legislated over, expressed as rules. For a legal positivist, the primary role of a judge is to determine what the law *is* with respect to the particular case in question. For Hart, there could be no such thing as judicial discretion – there could only be judicial discovery.

A key difference between Hart's positivism and that of his predecessors is the role he gave to the attitudes of those who recognise the rules. This 'internal' account contrasted with a purely external, or behavioural, account which paid attention only to patterns in actions and interactions. Hart is less clear on how a conventionally positivist account can be given of 'mental' attributes such as attitudes without reducing them to behaviour.

Hart distinguishes between three types of legal rule: primary rules, secondary rules, and rules of recognition. Primary rules are ordinary legislation – the laws that govern day-to-day actions and establish the practical rights and obligations which members of a group share. Secondary rules are, broadly, rules about what the primary rules should achieve. They spell out the purposes of the primary rules, and might, in some sense, be identified with 'principles' of legislation.

The third set of rules comprises rules of recognition as a particular class of secondary rule. Rules of recognition establish what do, and what do not, count as primary rules of law. Rules of recognition include, for example, constitutional arrangements for establishing legislation, explanations of how judicial precedent should be used, and the authoritative sources for common law.

A difficulty of the approach taken by legal positivism is that it has no straightforward method for dealing with rule incoherence. There is nothing essential to the positivist account that renders rule conflict invalid. If the law is to be coherent, this must be spelled out somehow by the rules of recognition or by the secondary rules.

Hart's critic Ronald Dworkin (1977, 1985 and 1986) addresses the problem of coherence by

giving interpretation a central role in jurisprudence. Dworkin also makes a useful distinction between rules and principles that deals with issues of coherence and contradiction in an elegant and consistent way. This distinction is based on how rules and principles work in adjudication: Dworkin says that a rule is absolute, that rules cannot conflict, and that there should be no ambiguity about applicability. Principles, on the other hand, may conflict. They need to be weighted, and their applicability to specific cases may not be immediately clear. (Dworkin also distinguishes principles from 'policies', which are the aims of some legislative programmes. Policies are political objectives and therefore, for Dworkin, outside the scope of legal decision making).

In jurisprudence, such a distinction clearly has a bearing on methods of judgement, on debates about codification *versus* precedent, and on the role of judges. Where a rule is shown to be incoherent or ambiguous, or where no rule applies, the role of the judge in adjudication is ineliminable. In accounting standard setting, we see clear parallels with arguments over the role of judgement, and the principles *versus* standards debate.

In Dworkin's terms, we can say 'In principle, income should be measured in a way which does not deceive or mislead users of accounts', and we can then ask a judge to decide what accounts do and do not conform to this principle. We cannot say 'The rule is that income should be measured in a way which does not deceive or mislead users of accounts' because we cannot render this into a set of unambiguous instructions; it cannot be 'programmed'.

A notable aspect of Dworkin's account is that it is irreducibly normative.¹⁶⁴ A principles based account depends, in a direct way, upon some system of morality. A system of morality cannot, without circularity, be a rules based system. Along with the role he gives to interpretation and judgement, this sharply distinguishes him

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from the positivists. His approach threatens to render the law ‘relative’ to culturally variable moral rules.

An example that may be helpful here is the example of truth telling. Clearly ‘One should tell the truth’ is an instruction with moral content, but it is also, for any usable language, an incontrovertible one. Consider its alternative ‘One is not obliged to tell the truth’. This second statement undermines its own veracity – if it is true, then it may not be reliable, and so may not be true. It is not possible to determine what this statement commits its speaker to, and so not possible to determine its practical meaning. Its very status as a statement at all is under threat. ‘One should tell the truth’¹⁶⁵ may be an example of a normative statement that cannot be false, in the sense that its contrary cannot be a valid move in a usable language game.

‘One should tell the truth’ must, in Dworkin’s sense, be a principle. It cannot be a rule, or be reduced to a set of rules, because this would generate an ‘open question’ paradox. Imagine how we might demonstrate that the rules we established for truth telling were the true rules – we cannot do this by referring to the rules themselves, since it is exactly their reliability that we are questioning. And we cannot refer to further rules since any further rules would not help us with adjudicating *truth* (since all the rules for truth telling are included in our established set).

Our situation here is not unlike the situation of Wittgenstein’s inarticulate rule follower, explained earlier. We can tell the truth, and must be able to if we are to speak at all. However, we cannot fully articulate how we do this – we cannot have an explicit *theory* of truth telling.

There is a symmetry between this central theoretical problem in the philosophy of language and the practical dilemma faced by the profession

whose work is based on the metaphor ‘to give a true account’.

7.3 Overview and comment

The philosophical and jurisprudential debate has two important outcomes:

- (a) Even apparently formal disciplines such as mathematics and arithmetic cannot be reduced to ‘rule following’.
- (b) Some normative categories (such as truth telling) cannot be reduced to rules and yet they are fundamental to rational discourse. These categories can be expressed in terms of normative principles.

There is nothing ‘unscientific’ or ‘irrational’ about principles-based approaches to objective representation. On the contrary, it is the insistence that only a rules-based approach can produce objective representation that turns out to be incoherent.

SECTION EIGHT - SUMMARY AND CONCLUSIONS

The purpose of this review of the professional, academic and regulatory literature is to provide background material relevant to the work of the ICAS Principles *versus* Rules Working Group. The review is not intended to provide a definitive conclusion to the debate; that discussion is taken forward in the main report of the Working Group.

It was apparent from the outset that a comprehensive review of all that has been written on rules and principles in accounting would be well beyond the scope of one piece of work. This has inevitably provided only a sample of the material available but has sought to represent the range of opinions and sources. The review moved from the particular debate generated by the failure of Enron (sections 1 to 3) to wider aspects of the nature of the accounting profession (section 4), the historical debate on accounting principles (section 5), related issues of convergence, comparability, consistency and culture (section 6) and the views found in branches of philosophy and jurisprudence (section 7). Each section has its own overview and summary.

The debate that has taken place since 2002 has been driven by the particular circumstances of concern for restoring lost confidence in the reliability of corporate financial reporting. Because the accounting standards themselves came under scrutiny there were calls for a root-and-branch change from rules-based to principles-based standards. However it could be argued that what was really under question was the ability and integrity of accountants and auditors in exercising judgement on the application of standards, whatever their nature. Examining the arguments for and against rules-based standards does not provide a basis for logical demolition of rules-based standards but equally it does not provide a logical platform of support and it points to some of the problems that rules-based standards have created.

The initiatives taken to create a more principles-based approach began with enthusiasm for the higher levels of professional judgement that could be applied under principles-based standards but then pulled back somewhat with the realisation that principles-based standards could unleash a monster that would run out of control. Discussion turned to 'objectives' and 'guidance' accompanied by words such as 'comparability' and 'consistency'.

The question of aptitudes and attitudes of professional accountants has exercised researchers for some time. It would appear from the evidence that professional accountants are more suited to a rules-based approach but it could be argued that they have been conditioned to this approach and could equally readily adapt to a principles-based approach under the right conditions.

It might be thought that the answer to questions about principles-based accounting could be found in the debates on principles that took place in the 1960s but it is difficult, if not impossible, to extract an objective set of principles from the subjectivity of opinions about the nature of principles and the structure of a theoretical framework of accounting. There are also lessons to be drawn from history in avoiding debates with no likely conclusion.

The importance attached to convergence of accounting standards across national boundaries is a feature that was not present in the debate on principles in the 1960s. This in turn brings in considerations of cultural differences and the extent to which these should be taken into account in devising principles-based standards with global application. Consideration of cultural differences leads to questioning the meaning of terms such as 'comparability' and 'consistency'. If these are taken to the extreme of treating all transactions of the same kind in the same manner, then comparability and consistency may be more apparent than real because companies in different countries may

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nevertheless apply different interpretations of the principles. It could be argued that allowing scope for interpretation leads in fact to greater comparability and consistency because the company has more freedom to represent economic reality as perceived by the management.

Examples of philosophical and jurisprudential debates on the meaning of ‘rules’ and ‘principles’ show that following rules does not provide a perfect answer, even in apparently formal disciplines such as mathematics or arithmetic. Principles of ‘truth telling’ may be expressed in principles that have a normative form, representing the judgement and opinions of those expressing the principles.

It seems likely that the ‘principles versus rules’ debate may well evolve into a question of ‘who makes the judgement?’. The evidence presented in sections 1 to 7 points to widespread endorsement of a focus on principles, with some questioning of how the ideal set of principles is determined. The conditions attached to support for principles are expressed in different ways such as a need for ‘guidance’ or ‘interpretation’. Some of these conditions are a thinly disguised attempt by interested parties to retain or impose control over the accounting agenda. Others are expressions of concern over the willingness and ability of practitioners to exercise good judgement within the greater freedom of principles-based standards. There is a risk of the debate on principles returning to the inconclusive debates of the 1960s because those involved in the debate do not recognise, or do not acknowledge, the spectrum of views that may exist within a framework aimed at convergence, consistency and comparability. It is also important to understand that principles in accounting will inevitably involve judgements based on society’s views of acceptable conduct.

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- ¹⁶³ Those familiar with Goodman's paradox (Goodman 1983) will recognise this as a variant.
- ¹⁶⁴ In the sense of being based on expected standards of behaviour.
- ¹⁶⁵ It is important to distinguish this from 'One should *always* tell the truth', which is demonstrably false.