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Research Report

Principles-based vs. rules-based accounting standards: The effects of auditee proposed accounting treatment and regulatory enforcement on auditor judgments and confidence

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ABSTRACT

Using an interest capitalization context, this paper examines the impact of accounting standard type (rules-based vs. principles-based) on the auditor's agreement with an auditee's proposed accounting treatment. Contrary to prior studies that have investigated lease classification contexts, results indicate that auditors are more likely to agree with the auditee's accounting treatment under a principles-based than a rules-based standard. The possibility of a Securities and Exchange Commission (SEC) investigation does not affect auditors' agreement with their auditee's accounting treatment. However, auditors are more confident in the rules-based scenario when they have no knowledge of a possible SEC investigation. Thus, the lack of precision inherent in a principles-based, interest capitalization standard may initially persuade auditors to agree with auditee judgments, but this perception may be moderated by a reduced level of confidence. Those interested in the standard setting process should look beyond the traditional lease structuring scenario and consider the possible effects of other principles-based standards on auditors' judgments and confidence.

Introduction

Over the past decade, United States (U.S.) accounting standard setters have experienced increasing pressure to modify the current accounting standard-setting regime. The initial incentive for change stemmed from the investor confidence crisis that occurred concurrent to the numerous accounting scandals that peaked with the Enron and WorldCom implosions and the demise of the famed accounting firm Arthur Andersen. The Enron fiasco has been blamed, in part, on the proposition that Generally Accepted Accounting Principles (GAAP) are rules-based. With the bright-line tests and detailed guidance inherent in GAAP, Enron's management, for example, was able to manipulate earnings by following the "letter of the law" rather than the economic substance of transactions (Business Editors, 2002; Schipper, 2003; Wriston, 2002).

In addition, movement toward a global set of accounting standards has placed the U.S. in a position to adopt or at least consider adopting standards that are less rules-based (i.e., that contain fewer 'bright lines'). Many regulators and practitioners consider International Financial Reporting Standards (IFRS) to be principles-based (e.g., Heffes, 2004; Securities and Exchange Commission (SEC), 2002, 2008) and,

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therefore, consistent with a desire to move away from rules-based standards.[1]

Several studies have experimentally investigated how accounting standard type (i.e., rules-based vs. principles-based) impacts auditors' judgments (Backof, Bamber, & Carpenter, 2011; Cohen, Krishnamoorthy, Peytcheva, & Wright, 2013; Ng & Tan, 2003; Segovia, Arnold, & Sutton, 2009; Trompeter, 1994; Ng & Tan, 2003). This study extends the existing body of research in several ways. First, prior research has almost exclusively focused on structuring leases (e.g., Agoglia, Doupnik, & Tsakumis, 2011; Backof et al., 2011; Cohen et al., 2013; Jamal & Tan, 2010). The lease classification case is a popular and logical case as it represents a familiar example of a 'bright-line' accounting standard under U.S. GAAP and is commonly cited as an example of a rules-based accounting standard (e.g., Agoglia et al., 2011; Collins, Pasewark, & Riley, 2012; Maines, 2007; Securities and Exchange Commission (SEC), 2003). Several parties involved in the financial reporting process believe that the specificity of lease classification rules, in particular, may diminish financial reporting quality. McEnroe and Sullivan (2013) surveyed auditors and CFOs regarding their perceptions of rules-based and principles-based accounting standards. Using a list of ten different situations where U.S. GAAP includes rules-based guidance, the authors asked respondents whether they believed that the elimination of a specific rule would lead to an increase in the "qualitative characteristics of useful financial information." For all but one of the situations, the majority of respondents agreed that the elimination of the rule would *not* enhance financial reporting quality. Lease classification represented the only situation where respondents were more likely to favor the elimination of a specific rule.

To provide evidence from a different perspective, the experiment in this study introduces an unexplored audit standard – capitalization of interest. The accounting standard for capitalization of interest differs from the lease classification standard in terms of precision. Whereas lease classification rules clearly contain all of the characteristics of a rules-based standard that strictly limit audit judgment (i.e., specific guidelines, elaborate rules, and, most importantly, bright lines), the rules-based standard for capitalization of interest contains no bright lines and therefore, provides more leeway for audit judgment.

Although capitalization of interest and the related standard are not frequently considered in the principles vs. rules debate, the Financial Accounting Standards Board (FASB) (2002) singled out the standard as an example of a rules-based standard and how it could be translated into a principles-based standard. Wording from ASC 835-20 (formerly SFAS No. 34) and the Financial Accounting Standards Board (FASB) (2002) provides the proposed principles-based standard in this study. Moving away from the lease classification standard to the capitalization of interest standard extends the generalizability of prior results.

Furthermore, the study introduces the possibility of an SEC examination. Adding a possible SEC examination provides insight into auditors' concerns that their judgments may not withstand the scrutiny of regulatory agencies when principles-based standards are applied (e.g., Herz, 2003; Wriston, 2002). Finally, the study examines the confidence auditors have in their judgments when presented with rules-based vs. principles-based standards. Evaluating this issue will provide additional insight into the judgment process itself as opposed to only examining the outcome of the judgment.

Results indicate that auditors are more likely to agree with an auditee's preferred accounting treatment in a principles-based capitalized interest scenario than in a rules-based scenario. However, the possibility of an SEC investigation did not differentially impact auditors' judgments. Finally, auditors presented with the rules-based standard and no mention of possible SEC examination were marginally more confident in their judgments than those presented with the principles-based standard or those provided with the possibility of an SEC investigation. Given the small sample size (61 auditors), further testing is recommended.

The remainder of this paper is organized as follows. The next section provides background about the principles-based versus rules-based standard setting debate and develops the hypotheses. The third section details the experimental methodology and the fourth section presents the results. The final section discusses implications of the results, limitations, and opportunities for future research.

Literature review and hypotheses development

Principles-based versus rules-based standards

Initial research in the principles-based versus rules-based standards debate focused on financial statement preparers' tendency to manipulate income under lease classification standards. Results of these studies indicate that financial statement preparers are more likely to classify leases as operating, relying on the 'bright lines' criteria under the more precise U.S. GAAP standard than under a less precise, principles-based standard (Agoglia et al., 2011; Bailey & Sawers, 2012; Jamal & Tan, 2010; Psaros & Trotman, 2004).

Auditors' judgments are also impacted by the precision of rules-based versus principles-based standards. For example, Cohen et al. (2013) manipulated lease classification standard type and find that auditors are more likely to constrain aggressive reporting under a principles-based standard than under a rules-based standard. Nelson, Elliott, and Tarpley (2002) conducted a field study where auditors believed that auditees were attempting to manage earnings. The authors categorized their data on two dimensions: precision of accounting standard and transaction structuring. The term precision of a standard referred to "a criterion that specifically allows or disallows a particular accounting treatment or that is specified numerically" (Nelson et al., 2002, 176) while transaction structuring referred to "management attempts to manage earnings by modifying contracts,

[1] Principles-based and rules-based standards are the extreme ends of a theoretical spectrum. In practice, all standards have some principles-based and some rules-based components (see Bennett, Bradbury, & Prangnell, 2006; Nelson, 2003; Schipper, 2003). The difference between U.S. GAAP and IFRS is the degree to which the standards are principles- or rules-based (Jamal & Tan, 2010).