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An examination of the perceptions of auditors and chief financial officers regarding principles versus rules based accounting standards

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ABSTRACT

The debate over the adoption of International Financial Reporting Standards (IFRS) by United States issuers, or its convergence with U.S. Generally Accepted Accounting Principles (U.S. GAAP) has been going on for several years now. However, as of this writing, the Securities and Exchange Commission (SEC) has still not taken a definitive position on the issue. This is in part due to issues involving the cost of adoption, independence concerns relating to the IFRS promulgation body, the International Accounting Standards Board (IASB), and the debate over which type of accounting standards is superior for financial reporting: IFRS, which are said to be "principles-based," or U.S. GAAP, which are said to be "rules-based." In this paper we examined the views of two stakeholders in the U.S. financial reporting system, auditors in large public accounting firms and Chief Financial Officers in the Fortune 1000. We elicited their perceptions involving ten situations where specific rules are incorporated in U.S. GAAP. We asked if the elimination of the specific rule would be likely to better achieve the "qualitative characteristics of useful financial information" as defined by the Conceptual Framework for Financial Reporting adopted by the Financial Accounting Standards Board (FASB) in 2010 (FASB 2010) and the similar document adopted by the IASB at the same time (IASB 2010). We found that in eight of the ten situations both groups preferred the rules-based accounting regime (the current U.S. GAAP rules) over a principles-based approach.

1. Introduction

As of July, 2012, non-U.S. companies using International Financial Reporting Standards (IFRS) are permitted to list their securities on U.S. stock exchanges without reconciling those statements to U.S. Generally Accepted Accounting Principles (U.S. GAAP). In 2008, the Securities and Exchange Commission (SEC) had considered a proposed rule (commonly referred to as the "SEC Roadmap") that, if adopted without changes, would have required all U.S. issuers to employ IFRS by 2014 and permit earlier adoption by some issuers (SEC, 2008). The extended comment period on this proposed rule has now expired and the Commission has not yet acted. However, in a subsequent meeting of the SEC (February 24, 2010; SEC, 2010a), the Commission unanimously approved a new timeline that envisioned 2015 as the earliest adoption date. The Commission also withdrew the proposed rules for early adoption of IFRS, with the option of reconsidering it at a later date (referred to as the "SEC Workplan" (SEC, 2010b)). As of this writing, the latest development is that in July, 2012, the SEC released a Staff Report (SEC, 2012) dealing with the potential mandatory adoption or voluntary use of IFRS by U.S. companies. This narrative underscores the

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considerable time and resources that the SEC has devoted to the issue.

Our research examines one issue included in the July staff report (SEC, 2012, 27) and in most other discussions of the possible adoption of IFRS for U.S.-based SEC registrants: the "principles v. rules" debate. The objective of our research is to examine the perceptions of two important stakeholders, public accountants and chief financial executives, regarding various financial attributes under a "principles" versus "rules" based accounting regime. Although we will describe our method and findings in more detail in a later section of the paper, we thought it appropriate to describe them briefly at this this time. We presented ten separate examples of the application of a rules-based system in U.S. accounting. Each of these examples involved a general reporting issue where U.S. GAAP provides detailed rules for choosing among reporting alternatives. For each of these examples, we asked whether the elimination of the detailed component of the rule and the related restriction of professional judgment would "improve" financial reporting. Our measure of improvement was whether the elimination of the detailed rule would result in financial statements that better represent the qualitative characteristics of financial reporting. We found that in all but one case, the accounting for leases, the average of the responses indicates that the respondents felt that the removal of the detailed rule would not result in financial reporting that better achieved the qualitative characteristics. In fact, in only two circumstances, leases and retail land sales, was there less than a majority that felt removing the detailed rule would hinder the achievement of the various qualitative characteristics. The results should be of interest to public accountants, those in industry, U.S. issuers, and other interested parties such as the SEC who will decide if U.S. firms will be forced to convert to IFRS. As we will explain in a later section, our research extends the literature in that it is not a traditional opinion survey, but rather examines the preferences of public accountants and CFOs for either a specific U.S. GAAP rules based approach or a principles based alternative in specific accounting situations. We begin our literature review with a brief review of research involving international accounting standard setting under the IASB realm, and continue with a discussion of the "principles" versus "rules" debate, which our research experiment focuses on.

2. Relevant literature

2.1. The accounting standard setting environment under the IASB regime

As in the case of the promulgation of certain U.S. accounting standards (accounting for employee stock options, oil and gas exploration, and accounting for the investment credit) there are also strong external forces that sometimes influence the development of IFRS. For example Luthardt and Zimmermann (2009) provide what they refer to as a "European" view on the legitimacy of accounting procedures used in developing accounting standards. They analyzed the accounting standard-setting process in Europe, which is a two stage process involving both private standard-setting and then public rule-making. They document the standard-setting process through a detailed flow chart. They conclude that, although the European Union (EU) is in a position to develop "legitimate" accounting standards, its "legitimacy" is endangered when its structures are utilized for policy formation generating what they refer to as "EU-IFRS." They warn that IFRS might be relegated to the status of a "'Label' accompanied by various local flavors" (Luthardt & Zimmermann 2009, 87).

Cortese and Irvine (2010) provide a more micro example of influences shaping of IFRS, in this case, accounting for oil and gas exploration. As in the U.S., there were two methods of accounting for these costs: Successful Efforts (SE) and Full Cost (FC). Basically the former capitalized only the exploratory efforts that reached fruition as opposed to the latter where all costs were capitalized and subsequently charged to depletion expense. In its Issues Paper, the International Accounting Standards Board (IASB) stated its preference for a single standard, and 78 per cent of the respondents to the paper indicated that SE should be required, with the other 22 per cent arguing for retention of the choice of either method. However, the accounting standard, IFRS 6, Exploration for and Evaluation of Mineral Resources, issued by the IASB in 2004, and effective January, 1, 2006, did not take a stance and allowed for the continuation of the use of either method. The authors attribute this outcome to what they refer to as the existence of a "black box" in which powerful industries and other coalitions influence the IASB on a covert basis to secure their goals. The authors document the contributions of the Big 4 to be approximately 60 percent of the IASB's 2006 funding. These audit firms, in turn, earn significant revenues from the extractive industries. Furthermore, three extractive industries were represented on the Steering Committee which was responsible for the development of the Issues Paper and IFRS 6.

In contrast to the above findings, Larson (2008) examined the comment letters associated with the treatment of Special Purpose Entities and found that, despite "adamant" lobbying, the final statement was stricter than the initial proposal. Specifically, the case involved a Draft Interpretation (DI-12) issued by the International Accounting Standards Committee's (IASC) Standing Interpretations Committee which would require more frequent consolidation of SPEs. Most of the comment letters supported the proposal, however about 25 per cent strongly opposed it, with the resistance coming from countries with more compliant SPE consolidation requirements, including all the U.S. respondents, one of whom was from the staff of the FASB. The author concluded that these letters had little influence on the final document, while many of the suggestions from the International Organization of Securities Commission (IOSCO) and other DI-12 supporters were incorporated.

As to the participation of accounting academics in the formulation of IFRS, Larson and Herz (2011) document that, although this group possesses the potential to have a "strong positive influence" in the development of accounting standards, their response rates are fairly low. For example, for 55 IASB issues, academics and academic