2004

Rules-based vs. principles-based accounting standards: Analyzing the impact of amending APB No. 18 to a principles-based standard

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Introduction

Significant events have had an impact on the accounting industry. Most recently the public discovery of Enron's fraudulent accounting practices and Arthur Andersen's subsequent attempt at a cover-up set the financial world reeling. Several other large companies were also later discovered to have engaged in fraudulent accounting practices. The discovery of corporate scandals led to a decrease in investor confidence and lack of investing. As Enron's activities went to trial, Enron's external auditor Arthur Andersen was also charged for obstruction of justice in the Enron scandals. Both Enron and Arthur Andersen were found guilty and they soon faded from the prominence they once held.

Several debates have arisen over what contributed to this corporate fraud and what could be done to prevent it in the future. One debate that arose was whether United States accounting standards were too "rules-based" and if a more "principles-based" system would be more effective. Congress's response to all the corporate scandal discoveries was the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act recommended that the Securities and Exchange Commission (SEC) conduct a study to focus an examination on the current condition of the accounting standard setting process and the potential implementation impact of a "principles-based" system. The Financial Accounting Standards Board (FASB) is also addressing the debate by developing a proposal to study "principles-based" standards. The FASB has also very recently released a proposal to change the accounting for stock-based compensation to be more principles-based. While both rules-based standards and principles-based standards have their argued advantages and disadvantages, I believe principles-based accounting

standards will not provide benefits significant enough to support a principles-based focus in United States standard setting.

Rules-based standards are standards that use "bright-line" tests or specific criteria, often quantitative criteria, to establish the difference between the possible accounting methods for a transaction. The American Accounting Association Financial Accounting Standards Committee (2003) discusses Statement of Financial Accounting Standards (SFAS) No. 13 *Accounting for Leases* as being a rules-based standard. SFAS No. 13 contains four criteria that result in a lease transaction being accounted for as a capital lease to the lessee instead of an operating lease. The four criteria are if the transaction includes a bargain purchase option, if the transaction causes title to pass to the lessee, if the time period of the lease is 75% or more of the asset's useful life, and if the lease will cover 90% or more of the asset's net fair market value. Schipper (2003) discusses SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* as being viewed as another rules-based standard. SFAS No. 133 contains nine exceptions to the definition of a derivative including "regular way" security trades, normal purchases and normal sales, certain insurance contracts, certain financial guarantee contracts, certain contracts not traded on an exchange, derivatives that serve as impediments to sales accounting, contracts both indexed to the reporting entity's own stock and classified in stockholders' equity, contracts in connection with stock-based compensation arrangements, and contracts issued as contingent consideration from a business combination. Schipper (2003) suggests several of the above exceptions were only included to reduce costs to preparers. Those against rules-based standards (SEC 2003; American Accounting Association Financial Accounting Standards Committee 2003; Nelson 2003) argue that

while rules-based standards allow for more straightforward implementation and enforcement, rules-based standards also allow for a disregard of the true economics of the transaction. They believe rules-based standards permit management to more easily manipulate the financial statements to appear as management desires. Consider SFAS No. 13 discussed above, if a company decided it would be more beneficial for them to have a lease be accounted for as an operating lease, they could structure the transaction to make sure it did not meet any of the four capital lease requirements. Opponents argue that the true economics of the transaction are being overshadowed by the guidelines of the standard causing financial statements to be less useful and more deceptive.

Principles-based standards are standards that use more theoretical and broad concepts to establish the difference between the possible accounting methods for a transaction. Principles-based standards require more judgment for implementation. Nelson (2003) discusses SFAS No. 5 as an example of a principles-based standard. SFAS No. 5 requires the recording of a loss contingency if the loss is "probable" and "reasonably estimatable." The determination of "probable" and "reasonably estimatable" requires judgment and an evaluation of the specific situation. Schipper (2003) discusses SFAS Nos. 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets* as also being "principles-based in that they require a single accounting treatment for all business combinations; they require fair value measurements of acquired tangible and intangible net assets; they require the recognition of acquisition goodwill as an asset that is to be subject to impairment testing and not to periodic amortization." Those who support principles-based accounting standards (SEC 2003; American Accounting Association Financial Accounting Standards Committee 2003; Nelson 2003) argue that

while principles-based standards lead to a more complex implementation and enforcement, principles-based standards also cause both management and auditors to evaluate the true economics of the transaction. They argue that financial statements would be more useful to the users because they would provide a more complete picture of the company's financial status.

A challenge that exists in defining rules-based versus principles-based accounting standards is that standards are not strictly rules-based or principles-based. The American Accounting Association Financial Accounting Standards Committee (2003) characterizes "the accounting standard-setting process and its products as a continuum ranging from unequivocally rigid standards on one end to general definitions of economics-based concepts on the other end." (see Exhibit A) Accounting standards usually contain both rules-based and principles-based elements that determine their place along the continuum. Consider SFAS No. 13 referred to above as an example of a rules-based standard. While SFAS No. 13 defines the four criteria that create a capital lease, the standard also includes an appendix discussing the basis for the FASB's conclusion including in paragraph 60:

> The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases.

SFAS No. 13 contains both rules-based criteria and the principles to support the criteria, but the principles behind the standard come mainly in the form of an appendix, placing SFAS No. 13 more towards the rules-based side of the continuum than the principles-based side. While SFAS 5 also discussed above does not include any

quantitative or object requirements to determine accounting treatment, so it would be placed on the extreme principles-based side of the continuum.

Literature Review

Research directly pertaining to the issue of rules-based versus principles-based accounting standards is rather limited, but various commentaries have been written, particularly since the enactment of the Sarbanes-Oxley Act of 2002.

Academic Research

Nelson, Elliott, and Tarpley's (2002) study is the most directly related to the issue of rules-based versus principles-based accounting standards. The study surveyed 253 audit partners about their experiences with 515 attempts by their clients at earnings management. The study produced two significant results. The study states:

> Our results indicate that precision and structuring interact in managers' and auditors' decisions: when transaction structuring is involved, managers are more likely to make attempts (and auditors are less likely to adjust attempts) that are governed by precise standards, and when transaction structuring is not involved, managers are more likely to make attempts (and auditors are less likely to adjust attempts) that are governed by imprecise standards.

The Nelson et al. study provides support that management transaction structuring would decrease with the implementation of principles-based standards. The deterrence of management transaction structuring is one of the largest arguments for principles-based standards.

The SEC also completed a study with a focus on four areas including the extent to which a principles-based accounting system exists in the U.S., the time required to change from a rules-based system to a principles-based system, the feasibility and proposed methods of implementation, and an economic analysis of implementation. The study believes a transition to principles-based standards is consistent with the objectives

of the Sarbanes-Oxley Act and includes a table of key steps necessary to for standard setting conversion and a time horizon for each step. The study recognizes implementation issues including the establishment of implementation guidance and redefinition of the GAAP hierarchy. The study also addresses economic and policy analysis areas including improved accessibility to and meaningfulness of financial information for investors, enhanced quality, consistency, and timeliness of standard setting, comparability issues, and transition costs.

Commentaries and Previously Analyzed Standards

Nelson (2003) reviews previous research to predict how participants in the financial reporting process are affected by rules-based and principles-based accounting standards. Nelson's conclusions suggest that accurate standard communication is created through a proper balance of rules, but not too many so as to overwhelm the practitioner. He further finds that aggressive reporting may best be constrained through incentives for accurate or conservative reporting and standards that are imprecise and offer no safe harbors. Finally he suggests that transaction structuring could be discouraged through guidance that uses examples instead of bright line tests and by enforcement of "substance over form" provisions.

Schipper's (2003) commentary is a narrative version of the discussion presented at the American Accounting Association Annual Meeting in August, 2002. Schipper discusses the current principles basis of accounting standards, why U.S. accounting standards are viewed as rules-based, effects of detailed implementation guidance, and potential issues with a shift to principles-based accounting standards. Schipper also

presents several empirical questions for future research. Schipper uses SFAS Nos. 141 and 142 as examples of the use of principles in setting accounting standards.

The commentary written by the American Accounting Association Financial Accounting Standards Committee (2003) was a product of a request by the FASB to provide comments on principles-based accounting standards and to recast two standards as principles-based. The commentary includes a discussion of principles-based accounting standards versus rules-based accounting standards, a review of related academic research, characteristics of principles-based standards, and implementation issues. The commentary concludes that a consideration of principles-based standards should be given priority by the FASB. The commentary also recognizes the implementation issues created by principles-based standards but argues that implementation issues would exist regardless of the standard setting form employed. An appendix includes SFAS No. 87 recasted as principles-based. The commentary indicates a recasted SFAS No. 133 can be found at http://www.aaa-edu.org.

An Analysis of Amending a Rules-Based Standard to Principles-Based

In considering previous research and the standards already analyzed as rules-based versus principles-based, I have chosen to analyze APB No. 18. APB No. 18 defines when the Equity Method is used to record investments in common stock versus the Cost method or consolidation. APB No. 18 states:

> The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other

> shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. When the equity method is appropriate, it should be applied in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.

APB No. 18 contains principles-based elements through its consideration of significant influence versus control. APB No. 18 dictates that an investment that lacks significant influence should use the cost method, an investment of significant influence should use the equity method, and a controlling investment should use consolidated financial statements. APB No. 18 even includes possible areas where significant influence could be determined. From a rules-based perspective, APB No. 18 then creates a presumption that an investment greater than 20% but less than 50% has significant influence and should be accounted for using the Equity Method. Investments greater than 50% are considered to be in control and should use consolidated financial statements, while investments less than 20% lack significant influence and should be accounted for using the cost method. APB No. 18 provides little support for how the 20% and 50% cutoffs were determined beyond 50% being the legal definition for control. It should be noted how APB No. 18 is impacted by SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities* (see Exhibit B). SFAS No. 115 creates two categories, trading securities and available-for-sale securities, for equity securities investments that lack significant influence. Trading securities are securities that are actively traded for the

purpose of earning gains quickly. Available-for-sale securities are securities that cannot be considered trading securities. Trading and available-for-sale securities are to be accounted for using the fair value method instead of the cost method described above. Under the fair value method, trading security changes in fair value are reported directly on the income statement as part of continuing operations. Available-for-sale security changes in fair value are reported on the income statement in other comprehensive income.

To analyze APB No. 18 as a principles-based standard, I will consider the impact that removing the 20% and 50% guidelines would produce. The examples of ways to exercise significant influence will remain and judgment will be necessary in order to determine if an investment should be accounted for through the Cost method (amended to fair value method as discussed above), Equity Method, or Consolidated financial statements. Removing the 20% and 50% guidelines would create a justifiable principles-based standard based upon the characteristics of principles-based standards developed by the American Accounting Association Financial Accounting Standards Committee (2003). The American Accounting Associations Financial Accounting Standards Committee's characteristics include the economic substance of the transaction guiding the financial reporting, a description of the particular transaction that is the subject of the standard, possible implementation guidance including examples of typical transactions, and disclosure requirements. Removing the 20% and 50% guidelines would require judgment about the substance of the transaction to determine if significant influence or controlling existed. APB No. 18 would still maintain its introductory definitions that describe the subjected transactions, the list of examples of areas where significant

influence could be exercised, and paragraph 20 that discusses disclosure issues for the statement.

Potential Impact of APB No. 18 as Principles-Based

In order to analyze the effectiveness of the new APB No. 18 as principles-based, I have chosen to consider the impact on three different areas including implementation of the standard, accounting objectives, and potential management transaction structuring due to the standard. Implementation is an aspect considered by the American Accounting Association Financial Accounting Standards Committee (2003) in their recasting of SFAS Nos. 87 and 133 and an area of study indicated by the Sarbanes-Oxley Act of 2002. Schipper (2003) supports the importance of accounting objectives in standard setting where she states, "The overarching concept is decision usefulness, supported by relevance, reliability, and comparability... The desire to achieve comparability and its over-time counterpart, consistency, is the reason to have reporting standards." Schipper (2003) also includes management transaction structuring as an effect of detailed implementation guidance. In determining my analysis, I will consider both the positive and negative aspects the principles-based standard could create.

Implementation

When considering the impact of implementation of a principles-based APB No. 18, it is necessary to consider the impact on both management and auditors. According to *Accounting Trends & Techniques* (2003), of the 600 annual statements of merchandising, technology, and services corporations that were surveyed, 74% owned noncurrent investments that accounted for using the fair value method or the equity method and, therefore, would require analysis in order to comply with APB No. 18. The management

of 74% of the companies in business and 74% of audit clients would be impacted by the change and required to alter their investment analysis. Implementing a modified APB No. 18 would impact a significant amount of companies.

A principles-based APB No. 18 would require judgment in order to determine the proper accounting treatment. The 20% and 50% guidelines would not be available as a crutch to make fast and easy decisions. Management would be forced to consider its ability to influence the investee to determine proper accounting treatment. Applying judgment to each investment will require more time and money than used to be necessary to analyze investments. While it will take extra time for management to analyze investments, it will also take more time for auditors to analyze their client's investments. The increase in implementation judgment opens several areas for further research: Will management take the extra time necessary to properly analyze investments; Will auditors also take the extra time necessary to properly analyze investments? How much extra time and money will be required due to the increased use of judgment?

Accounting Objectives

Comparability. One of the most important objectives to be considered in the current environment of investor uncertainty is comparability. Schipper (2003) discusses how an argued advantage to rules-based standards is improved comparability. She states "That is, specific guidance on how to apply a standard should reduce the effects of difference in professional judgment." When all companies are following the same "bright line" guidelines, some would argue financial statements are more comparable because similar transactions are all being subjected to the same objective criteria to determine accounting treatment. Schipper (2003) does recognize that inappropriately

strict guidance could still cause dissimilar transactions to use the same accounting treatment. The study conducted by the SEC (2003) argues that comparability would be increased with the use of principles-based standards. The study suggests that rules-based standards provide less comparability because practices to avoid certain rules-based requirements reduce transparency and genuine comparability, rules-based standards could be inappropriately rigid and cause similar transactions to use the different accounting treatments, and the clustering of transactions on either side of a "bright line" requirement could cause different accounting treatment for similar economic transactions. I would also argue that removing the guidelines from APB No. 18 could actually increase comparability. Without the guidelines, auditor and management judgment would be necessary to determine if an investment allows for significant influence or control. Each economic situation would be analyzed and ideally given the proper treatment. I believe judgment could more accurately identify transactions than arbitrary numbers and allow for improved comparability.

The above analysis does require certain assumptions to exist in order for comparability to be improved. The largest assumption relies on auditor and management judgment to be accurate in analyzing the investment transactions. If transactions are classified differently due to the variations in judgment of auditors and management, comparability is no better than it was with the guidelines in place. In fact, it could be argued that comparability would actually be worse. The assumption of accuracy currently casts a significant amount of doubt on the potential success of principles-based accounting standards. The doubt could potentially be dissipated or affirmed through

further research to determine how realistic it would be that management and auditors would spend extra time analyzing investment transactions?

Consistency. Along with investors needing confidence in the ability to compare one company to another, investors also need confidence in the ability to compare the company to itself from year to year. The transition from APB No. 18 as rules-based to principles-based should not create a significant impact on consistency. Rules-based APB No. 18 would require management to consider any changes in ownership interest and the ability to influence the investee from year to year to determine if the investment is still receiving proper accounting treatment. Principles-based APB No. 18 would require similar analysis from year to year to determine if the ability to influence the investee had changed. The 20% and 50% guidelines just would not be available as crutches to try to easily analyze the investment. Under either version of APB No. 18 the company would still be following the guidelines of the same standard from year to year. A principles-based APB No. 18 would not lead to improved consistency compared to the consistency already present under a rules-based APB No. 18.

Reliability. The issues a principles-based APB No. 18 would create for reliability are very similar to those created for comparability. The removal of the 20% and 50% guidelines would lead to management and auditors having to analyze each investment to determine the significant influence on the investee to know how to account for the investment. Accurate analysis would lead to investments being accounted for correctly and increasing reliability. Increased reliability still depends on the reasonably doubtful assumption, and area for further research, that management and auditors are going to take the time necessary to properly determine the influence upon the investment.

Transaction Structuring

The final area I would like to consider in respect to the potential effectiveness of a principles-based APB No. 18 is the ability management would have to structure transactions to acquire the accounting treatment desired. To determine if a principles-based APB No. 18 would prevent transaction structuring, it is necessary to consider how APB No. 18 could be manipulated in its current rules-based form. Foust and Henry (2002) and Meyer and Owsen (1998) would argue that Coca-Cola Company is currently manipulating APB No. 18. They argue that Coca-Cola Enterprises, Inc. should be reported in Coca-Cola Company's consolidated financial statements. Coca-Cola argues that its 38% ownership interest does not require consolidation and can be reported through the Equity Method. Based upon rules-based APB No. 18, consolidation would not be necessary for ownership interests less than 50%. Foust and Henry and Meyer and Owsen suggest that Coca-Cola Co. in substance controls Coca-Cola Enterprises and fights to avoid consolidation in order to make Coca-Cola Co.'s financial statements look more positive. Foust and Henry present data showing the significant impact consolidation would have upon Coca-Cola Co.'s return on assets. In 2001 Coke reported a 17.5% return on assets. Coca-Cola Enterprises reported a 1.9% return on assets. If Coca-Cola Co. had consolidated Coca-Cola Enterprises the reported return on assets would have been 7.5%.

While Coca-Cola is an example of how the 50% criteria of APB No. 18 could be used to structure transactions, I would also like to present an example of how the 20% criteria could be used to structure transactions. Consider a company with a 24% available-for-sale equity security interest in an investment without significant influence.

With the existing 20% criteria a company could argue their investment should be recorded using the equity method, allowing the company to record 24% of the investee's income directly on their income statement. The true economics of the transaction would lead the investment to be recorded with the fair value method, so the company would only be able to record the change in fair value of the investment in other comprehensive income. Even if rules-based APB No. 18 possesses the potential to be manipulated, it is necessary to determine if a principles-based APB No. 18 would prevent the transaction structuring.

The results of the Nelson et al. (2002) study suggest that management would be more likely to attempt earnings management with transactions structuring to meet the requirements of a rules-based APB No. 18 than they would with a principles-based APB No. 18. The results also suggest that an auditor would be more willing to allow the client to achieve the accounting treatment it desired when a rules-based standard applied to the transaction. Both results indicate that a principles-based APB No. 18 would help to decrease management transaction structuring. Financial statements would arguably become a better tool for investors to use to make decisions again assuming that necessary auditor/management judgment is accurate. While the prevention of management manipulation is a reasonable arguable advantage, I do not believe it is an advantage that is significant enough to outweigh the arguments and marginal benefits presented above particularly when its success is still subject to the assumption of accurate auditor/management judgment.

Summary & Conclusion

In the above analysis I considered the impact of amending APB No. 18 to a principles-based standard upon implementation, accounting objectives, and management manipulation. The analysis has uncovered both positive and negative aspects to a change in the accounting standards setting process. Implementation would be more costly and require more resources due to applying judgment instead of objective tests. Accounting objectives of comparability and reliability could arguably be improved assuming implementation is accurate. Principles-based accounting standards would not significantly improve consistency. Management structuring of transactions could be decreased assuming accurate implementation. The analysis has discovered that the potential success of principles-based accounting standards depends upon accurate judgment being used by auditors and management in analyzing transactions. I do not believe the potential benefits of principles-based accounting standards outweigh the extra resources necessary to ensure the use of accurate judgment and the doubt currently inherent in the assumption of accurate implementation.

The above analysis does not constitute a complete study of the debate of rules-based versus principles-based accounting standards. The analysis includes only a portion of the arguments and issues present in the debate, although I feel the arguments and issues presented are some of the most significant to the debate and allow for a sufficient conclusion to be drawn. I recognize that the arguments above include a significant amount of speculation and do not provide a definitive answer, but I believe the analysis provides a basis that shows the importance of future research in order to determine the most effective method of standard setting for the accounting industry.

In order to provide a more definitive answer in the debate of rules-based versus principles-based accounting standards, more research is necessary to answer the questions that remain within the analysis above and questions that remain for a further analysis of the debate as a whole. The questions that remain with respect to implementation, comparability, and reliability include whether management and auditors will take the necessary time to analyze transactions on a principles basis and if so, how much extra time and money will the implementation of judgment cost the accounting industry. These are the most important questions to be answered in order to provide a more definitive answer for the analysis above. In order to explore further the debate of rules-based versus principles-based standard, it would be necessary to analyze other standards that are perceived to contain rules-based elements to determine if similar conclusions are produced.

Resources

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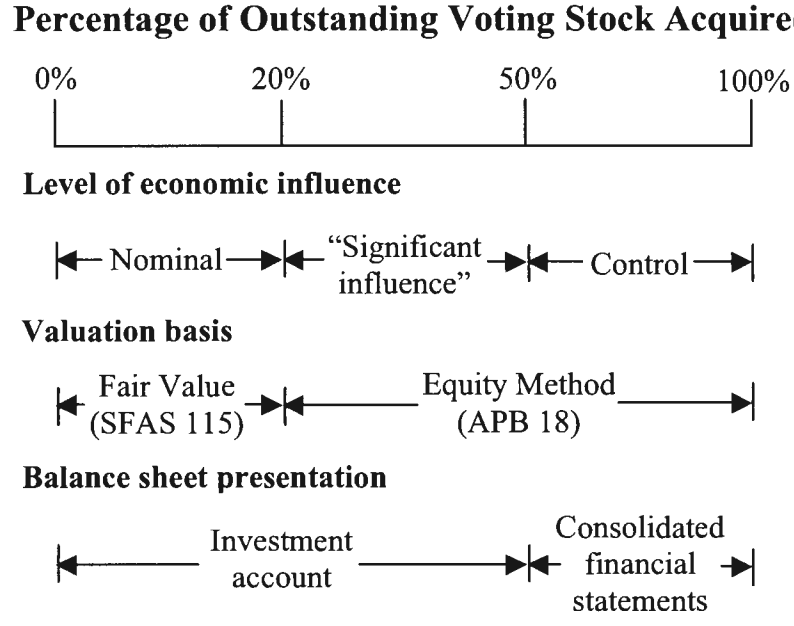
Exhibit A

Rules-based versus Principles-based Continuum

Exhibit B



Source: Whittington and Delaney (2004)